VENTURING IN CHINA ... !

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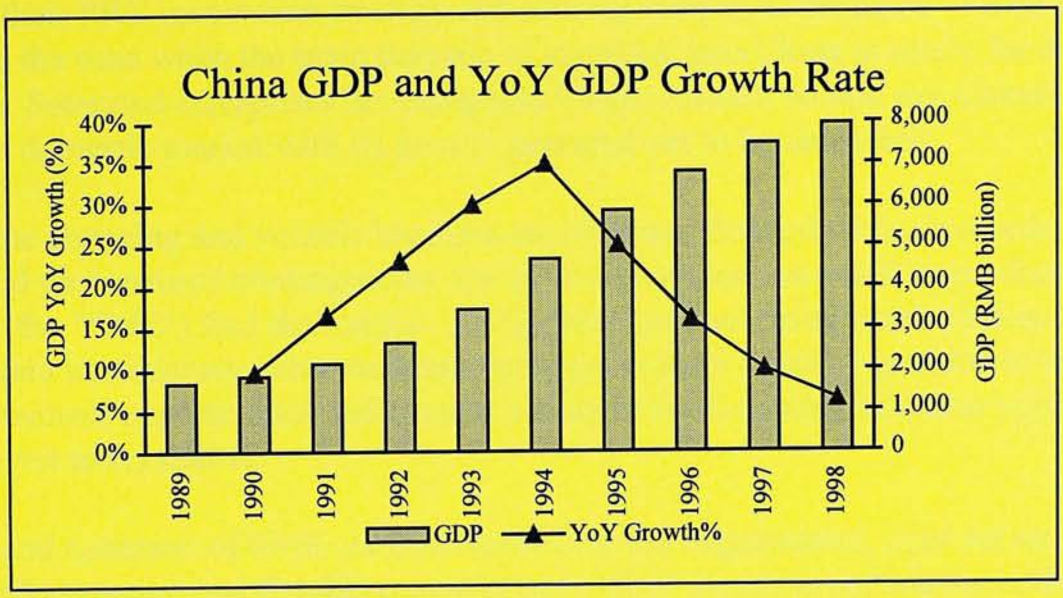
Prologue

The early 1990's China Fever has definitely come to a moratorium ----- despite it may be an overstatement to describe the investment climate of China using vocabularies like "lackluster", it still comes to reason that time has come for foreign investors to re-think (and re-invent) their China investment strategies and implementation plans.



Year 1999 could be the "Year of Consolidation" for China's foreign direct investment momentum. It would be constructive to the investor community for us to

(1) recap what has happened to China in the last 2 decades,
(2) acquire a profound understanding of where China stands in the international investment arena, and
(3) figure out where China is going in the years to come.

Although China remained relatively immune to the Asian financial turmoil, its growth momentum was overshadowed by the declining influx of foreign capital. Such decline may stem from the increasing competitiveness from China's neighboring Asia Pacific countries. Currency devaluation of China's Asia Pacific neighboring countries wear away China's traditional cost advantages.

It is undeniable that what makes China appealing to international investors in the past could no longer be an amulet for China to survive the after-shocks of Asian financial turmoil, not to mention further developments. This calls for the importance of adopting "anticipatory approach" in investment planning. This "pro-active" approach is essential to Chinese government for their strive to entrench the building blocks for Chinese economic growth engines. The same goes for entrepreneurs making business ventures in China. The key to business success is a "pro-active" approach instead of an "opportunistic" one.

To be frank, the Chinese government already did a great job in paving (on anticipatory basis) the way for foreign investors by:

- Institutionalising a better legal (and enforcement) system

- Fostering a less monopolistic economic structure (which demolishes most entry barrier)
- Levelling the business battlefield and making it a more competitive one, and
- Reiterating its clear intention to rely on market mechanism
  (Their intention has been, insofar, forcefully supplemented by consistent policy changes)
- Rolling out a number of profound technocrat-led structural reform to the economy

All these give rise to a "better" business-operating environment for foreign investors to implement their PRC investment strategy and develop their PRC presence. To be frank, we have passed the time when the main purpose of investing into China is solely for its cost advantages. Seasoned enterprises investing into China, instead, should eye China's magnificent domestic market with its growth potential yet to be unleashed.

In light of the changing and volatile business environment flooded with unprecedented demands and unstructured contingencies, the agile and responsive small-to-medium sized enterprises (the "SME") find their niche. Being small and not being hands-tied-at-back by the rigid corporate bureaucracy, their responsiveness gives them a unique position to capture emerging business opportunities and even to anticipate forth-coming business opportunities, which have yet to crystallise.

Flexibility and openness of SME are built upon their flat organisation, light yet strong corporate infrastructure and flexible cost structure. They are set to participate in the growth process and share the fruit of Chinese economy. Their only problem is … .. how to secure the necessary expansion capital to realise their enthusiastic business plan (especially in the widespread credit squeeze in the post-Asian financial crisis arena)! This report will touch a bit on the SME growth patterns and offer non-traditional alternatives to fund their business growth.

This changing business horizon in China also gives significant bearing to multinational corporation ("MNC") operating in matured market (say US and European markets) where business and political risks are low BUT market demand is saturated and growth potential is low.

For MNCs with well-founded business operations in saturated market sitting on a pool of recurring cashflows, they should set for direct investment in China (or other emerging market economies). From a global risk management perspective, they could comfortably allocate a (relatively small) portion of their assets and resources to China market without significantly increasing their global business risk. If they are sitting on a portfolio of low-risk businesses in matured markets, tapping into the high-risk emerging markets in search of revenue and market share comfortably allocate a portion of their assets and resources to China market without significantly increase their overall business risk is a natural strategic choice.

The 21st century contemporary business foresight has nothing to do with "risk-aversion" but closely associated with "global risk management" instead.

The main focus of the report ... ... !

This report is narrowly focused at the Chinese venture capital industry and seeks to devise a road map for venture capital houses operating in China. Through discussions on evolution of the industrial policy in China, PRC experience and lessons learned from industrial players, analysis of driving forces and growth factors for the industry, we could also explore how the Chinese institutional factors has been improved in the past decades. From which, we may have a better understanding of how China is and where it is going!

How this report could be useful ... ... !

This report also serves to, indirectly, introduce the concept of venture capital financing to emerging businesses in the region. The author will further elaborate in the main text how the SME proved to be an enormous growth propellant for the region's economic development. For these SME, venture capital could be an important alternative non-banking source of expansion capital.

For existing foreign investors in the Chinese battlefield, this report highlights a bit on how their peer groups are doing in China. The report also comes with a brainstorming section, which sketches the foreign investors' roads ahead, and shares some business brainchild thus unfold. This could possibly help them in re-aligning their action steps and re-deploying their corporate resources and management efforts.

For potential foreign investors eye on the PRC market, this report delivers a basic overview on China's investment climate and business peculiarities. The author will also share his views on how China could, on a going-forward basis, enhance its international competitiveness. Such desirable improvements could serve as a benchmark for potential foreign investors in devising their China investment strategy and action plans.

A brief wrap up on betterment of Chinese institutional factors ... ... !

What the author has made clear through this report is how foreign investments could nurture

(1) a more consistent government policies,
(2) a more transparent regulatory framework and enforcement,
(3) a more open domestic business practices and norms,
(4) a more efficient domestic finance market.

All these contributed to mark a number of milestones in making China (1) a better place for foreign direct investments, (2) a less monopolistic (semi-deregulated) market, (3) attaining a lowered entry barrier, (4) offers lower business transactions and agency costs.

This report could, in this regard, be considered as an informal logbook jotting China's efforts in reducing its business risks and the degree of uncertainty to foreign investors.

For the dedicated crusaders of

Asian Venture Capital industry ... ...

the region's admirable shareholder-value architects.

With a 1.2 billion-strong population, coupled with one of the region's highest economic growth potential, China has long been considered as the powerhouse for Asian's economic growth and development.

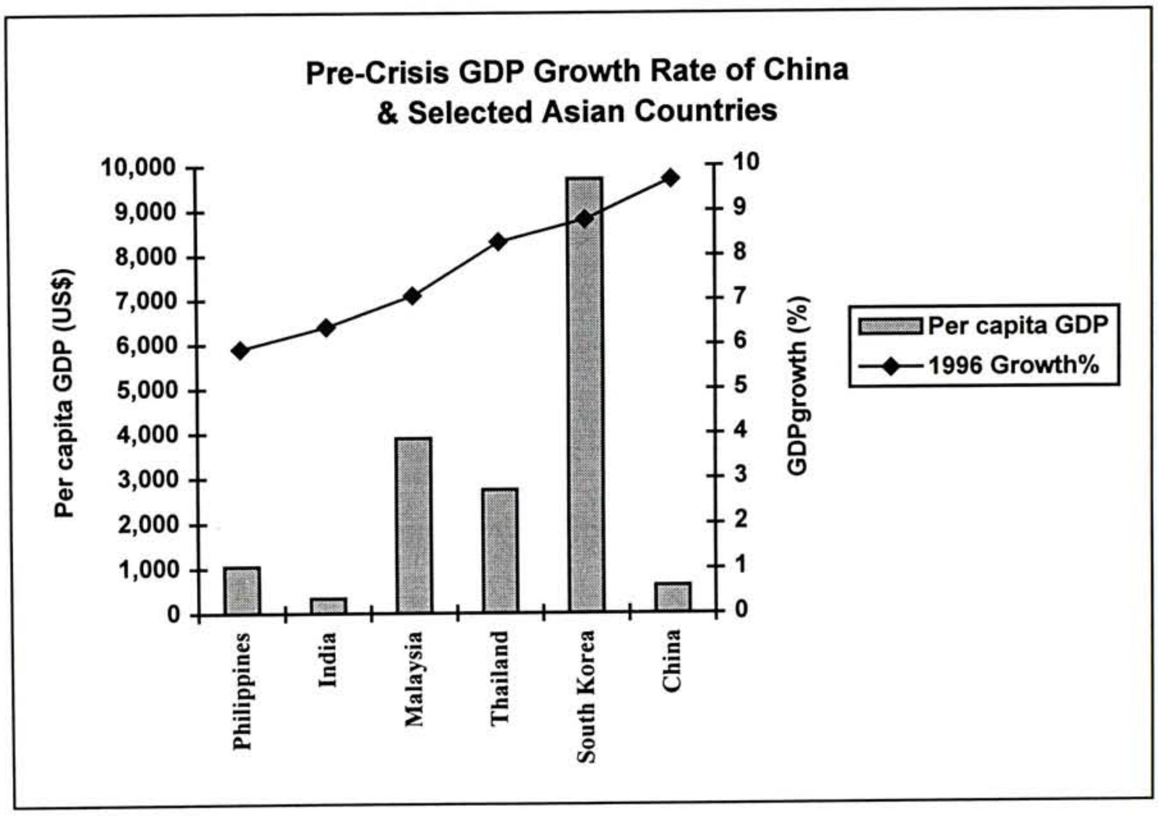
After almost two decades' phenomenal growth and amid the Asian recovery period in the post-Asian financial crisis era, it comes to a time for us to re-visit the China growth drivers and inhibitants. It's also a time for investors to re-define & re-deploy their China development plans according to earlier lessons.

Despite, the relative immunity of Chinese economy from the Asian financial crisis, there is no guarantee for China's future prosperity. The post-Crisis liquidity squeeze already hindered, and even suffocated, the growth of many Chinese enterprise, both domestic or foreign-invested ones. During the post-Crisis time, the once impetus "growth companies" place *survival*, instead of *sustainable growth*, top on their priority list.

The region's commercial banks traditionally downplayed the importance of emerging businesses in the economic structure. These growth companies takes up the larger chunk of the bitterness coming from the credit dry-up. Under this stressful situation, opportunity comes up for venture capitalists to step in and nurture the next wave of Chinese economic boom. Hand-in-hand with the influx of expansion capital from these seasoned venture capitalists, I believe the institutional factors will naturally improve and give rise to a more-friendly investment climate in China. This, in turn, will further enhance China's attraction to foreign investors.

Preliminary

The 1997 edition of China Statistics Yearbook indicated that the population of China already reached 1.2 billion. The young population[1] coupled with one of the region's highest economic growth potential and household saving rate[2], China offers considerable room for growth and development.



Source: China Statistical Yearbook / World Bank

Over the past decade, business and economic environment of China have been developing at tremendous pace which is in line with China's rapid economic reform

[1] China Statistics Yearbook 1997 indicated that 60% of the Chinese populace is below age of 35.

[2] Asian Development Bank reported that the 1998 gross domestic saving of China already reached 38.8% of its GNP.

and growth. This is further exemplified (by recapping from the China Statistics Year books) the growth of China retail market at an average growth of 18% during 1985 to 1996 ---- way ahead of the 11% average inflation rate for the period.

Where China is and Where it is Going

Common to other emerging market flourishing economies, China showed the same post-exponential-growth syndrome as well. In view of the recent Asian financial turmoil & the liquidity squeeze that follows, a "Financing Gap" has evolved.

The proliferating post-Crisis panic among the financial institutions triggers an indiscriminate credit shrinking. Even fundamentally sound enterprises with good growth prospect are having trouble even in maintaining their existing bank credit facilities -- not to mention secure new credit lines. This leads to escalating difficulties for growing companies to fuel its development with the necessary "expansion capital".

At the same time, ironically, we saw over US$31 billion[3] investment money chasing after China investment deals with barely half of this amount committed. Some commentaries even claimed in the pre-Crisis arena, competition among investment houses has driven investment projects unreasonable costly.

Of course, it is undeniable that buying into attractive and promising enterprises are still costly even in the post-Crisis time despite the general trend of

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[3] Fannin, Rebecca A. "The Great Capital Gap". Asia, Inc. December 1995 / January 1996: 40-45.

competitive-pricing of investments in the Asian countries. (To be frank, in the post-Crisis era, it is much easier for promising companies to distinguish themselves among their peer groups and thus demand for a much higher premium to financial investors.)

To fuel the future Asian economic development, there is a pressing need to bridge this macro-liquidity mismatch which could dampen the region's recovery and growth!

The Post-Asia Financial Crisis Investment Climate

Professor Krugman of Massachusetts Institute of Technology attributed the 1997 Asian financial crisis to be a punishment for the *Asian sin* of "crony capitalism" it is

> *a problem of moral hazard in extending credits (both domestic and overseas lending) to favoured economic sectors & companies where government is perceived to provides unreserved support (thus, implicit guarantees) for favoured borrowers.*

The authors considers "Moral Hazard" to be explicit (or implicit) public and private sector activities that encourage encouraging reckless behaviour in the belief that the culprit will always be bailed out.

Other prevailing variants of this *Asian sin* include government directives seeking Asian domestic financial institutions to extend credits to preferred businesses (say, to finance Korean government-picked chaebols, Malaysian 450-meter landmark

Petronas Twin Tower, the world's tallest commercial complex, or Suharto's family-linked Indonesian businesses).

This is an undue influence, or at least an invitation, to excessive credit risk-taking among financial institutions. The author agrees, in principal, with Krugman's criticism and considers this an Asian-mutant of "ineffective financial market regulation and credit control".

Accordingly, the key to Asian economic recovery is not "across-the-board" credit retrench but a "regulated credit process and post-draw-down monitoring".

Elixir to Assuage the Asia Financial Crisis

We have to accept the short-term pain of letting the inefficient companies go bankrupt and simultaneously sustaining momentum of growing companies. I believe during this tough time, it is those companies who could build up their muscles will survive the cut and wait for their turn to fly high in the next economic up-swing.

I believe the "*3R Principle*" could bring our Asian economies to rescue i.e. RE-DEFINE, RE-PRIORITISE and RE-DEPLOY.

The Asian countries need to **re-define** their competitive strength and weakness and **re-prioritise** their resources. The most important (sometimes painful) step is to have (government and private) financial resources siphoned to the most viable businesses and re-vitalise the country's economy by **re-deploy**ing their respective government and private sector resources. Such re-deployment must be conducted by sticking to vigilant business evaluation and viability test.

Given the (1) severity and proximity of the Asian economic crisis, (2) its devastating impact that sweeps through the region and (3) the lack of a quick and straight-forward remedy, we see a tremendous need for expansion (at times even survival) capital. This provokes an immediate need for longer-term and stable source of capital for the Asian enterprises.

This Asian enterprise survival problem is magnified by the post-Crisis "across-the-board" liquidity and credit squeeze that follows. The cash-starved enterprises, in the absence of traditional source of financial (in the form of debt or public equity including bank loans, bonds, IPOs, rights issues etc.) are facing increasing difficulties in bridging the financing gap.

Asian Invitations to Venture Capitalists

This wide-spread hunger for long-term capital offers much opportunities for venture capitalists. Now, the emerging enterprises and entrepreneurs are more willing to accept lower valuations and significant equity-entry discounts.

It is undeniable that the forthcoming private equity transactions in distressed Asian countries will be very different from traditional direct equity investments in a number of ways. This include (1) the complexity of deal structure, (2) lengthy negotiation due to increased number of stakeholders, (3) difficult choices in deciding which business to keep and which business to abandon. Among these, the *fundamental* challenge is to identify the real enterprise core competence and turnaround the business by leveraging upon this core competence.

What Venture Capitalists can Offer in Asia

The venture capitalists could provide valuable strategic advice and other value-added services to the Asian enterprises. On a going-forward basis, the venture capitalists can

1. work together with entrepreneurs as a value-adding business partner,
2. bring additional diversity of management insights to the investees companies; and
3. optimise the sourcing and application of expansion capital over time.

This radical change in this set of post-Crisis business environment presents itself to venture capitalists a broadened domain of requirement that calls for more disciplined and value-oriented approach than before.

The Asian financial crisis posted a new face to the overall business environment in Asia. In this dynamic and rapid-changing post-Crisis environment. there are much flexibility open to the business community in their strive to revive the ailing economy. These new challenges perfectly illustrate how energetic corporations, innovative entrepreneurs can join professional financial investors in paving a tremendous success and improving the macro institutional factors.

Business Environment	Pre-Crisis	Post-Crisis
Money supply	o excess liquidity pouring into money market and sparked enormous asset value inflation	o indiscriminate roll-out of recessionary monetary policy may even suffocate enterprises with sound fundamentals
Provision of credit	o ill-regulated bank lending and easy credit	o dry out of bank lending o even fundamentally sound enterprises are difficult in getting essential working capital and trade financing
Regulatory framework	o inadequate regulatory infrastructure / cultural differences not adequately recognised	o aroused awareness in the regulator & institutional level to regularise the playing field
Investment sentiment	o abundant idle money chasing after investment projects and drives investment return unreasonably low	o investment money vanished and projects are evaluated by extravagant (even unhealthy) level of risk-aversion o enterprises may have to seek non-bank alternative source of financing (offer potential for venture capitalists to share financial success in the next economic up-swing)

The industrial analysis on China venture capital industry will exemplify how the following institutional factors can be improved and moulded by foreign direct investment and institutionalised venture capital industry which tapped the China market:

1. stage of economic development;
2. government regulatory framework and policies;
3. source of domestic funding and financing;

4. local business practices and norms; and
5. capital market structure.

Several institutional factors including (1) regulatory changes, (2) participation of institutional investors as well as (3) increasing maturity of the industry itself propelled the development of venture capital industry in the more developed countries. A similar set of industry growth drivers and development trend also evidenced in Asia Pacific and China. This illustrated the importance of institutional factors in shaping economic development and business growth.

All these post-Crisis changes in institutional factors that significantly altered the Asian investment climate render Asian the dreamland for venture capitalists who have been stereotyped by Mr David Hartford, the Chief Investment Officer of Pioneer Poland Fund, as "*unlikely people financing unlikely things in strange places and interesting times*".

Lessons to Learn and Message to Deliver

To have a meaningful and more focused analysis on how venture capital industry evolves in this Asian emerging market, the author will focus the report scope at Mainland China and seek to dissect China's peculiar institutional factors.

Venture capitalists, in fact, started tapping the Chinese market since 1980's and have since then changed a number of China institutional factors in making China a better place for foreign investors. This report seeks to analyse the underlying drivers and growth factors of foreign direct investment in China which nourished the venture capital industry.

The main purposes of this report are,

1. explore development history of venture capital industry and highlight their evolution in Asia Pacific.
2. conduct a structural analysis on China venture capital industry, to look into drivers and inhabitants for the industry's growth in China.
3. develop a set of critical success factors for venture capitalists tapping the China market.

After charting an after-the-fact re-cap of the industry's milestones and its contributions to the emerging economies, the author will supplement this with structural analysis for this industry using Michael Porter's industrial analysis model. The author also seek to devise a road-map for a 21st century model venture capital investment house from the industry's China critical success factors.

VC

Abstract

Venture capital is a specialised investment product originally pioneered in the United States (which could be dated back to 1946). In the world's more developed economies, venture capital financing is an important source of expansion capital for start-up, private middle-market, and even public firms. The author will analysis how the industry players could "ride" the liquidity squeeze in the post-Asian financial crisis era which suffocates the region's once-impetus emerging businesses.

The author will focus the report scope & look into issues that shape the growth of venture capital industry in China by conducting an industry analysis covering

1. entrepreneur's requirements for expansion capital in the post-crisis era,
2. trends of China foreign direct investments, and
3. lessons learned from evolution of venture capital industry in more matured markets,

Based on the above analysis, the author will propose recommendations on

1. Critical success factors for venture capital house operating in China,
2. Model venture capital investing house, and
3. Road-map for a 21st Century Model Investment House.

In devising this strategic plan for a venture capital house investing into China, the following Chinese peculiarities will be analysis and associated, namely, (1) China investment horizon, (2) regulatory restrictions and concerns, as well as (3) domestic business practices to devise.

Chapter 1

Introduction

Over the past decade, business and economic environment of China have been developing at tremendous pace which is in line with China's rapid economic reform and growth. This is further exemplified by (as recapped from the China Statistics Year books) the growth of China retail market at an average growth of 18% during 1985 - 1996 ----- way ahead of the 11% average inflation rate for the period.

In this report, the author seeks to exemplify how the following institutional factors can mould the growth of an emerging industry and industry practices:

1. stage of economic development;
2. government regulatory framework and policies;
3. source of domestic funding and financing;
4. local business practices and norms; and
5. capital market structure.

All these institutional changes could be illustrated in the course of highlighting the history of foreign investors and venture capitalists establishing their China business outposts.

China market has long been perceived to offer considerable room for growth and its attractiveness comes from:

1. China's 1.2 billion strong population with 60% of its populace below the age of 35[1];
2. one of the region's highest economic growth potential; and
3. one of the region's highest household saving rate (1997 gross national saving amounted to 38.6% of GNP as reported by the Asian Development Bank),

Over the past decade, business and economic environment of China have been developing at tremendous pace which is in line with China's rapid economic reform and growth. This is exemplified by its domestic retail sales which exhibited an average growth of 18% during 1985 -1996 ---- way ahead of the 11% average inflation rate for the period.

Under the dynamic and volatile post-Asian Financial Crisis ("Post-Crisis") era, Chinese enterprise (both domestically-owned and foreign-invested) encountered unreasonable hurdles in raising expansion capital and even daily working capital. The liquidity squeeze after the Asian Financial Crisis and the fear of Renminbi devaluation retarded the enthusiasm of foreign direct investment in China.

The author does not intend to have a detailed discussion on Renminbi stability, however, the author still recognises the importance of currency stability (and strength) in determining a country's global competitiveness. The following grid tabulates some important forces shaping the Renminbi stability and lays the founder-stone to precede other discussions on macro-economic issues that follows in this report.

[1] China Statistics Yearbook 1997 indicated that 60% of the Chinese populace is below age of 35. (Unless otherwise stated, all China-related statistic information is recapped from the China Statistical Yearbook of respective years.)

Renminbi Stability ?!

(Note [2]) Not immune from Asian Financial Crisis	o China does not have full immunity from Asian Financial Crisis. Falling international competitiveness resulting from its strong "currency" will lead to slower growth from decreasing exports and foreign direct investment.
Losing international competitiveness	o Foreign direct investment will be squeezed by recession in Asia. The March 1999 EIU country report indicated more than 68.1% of the 1998 actual FDI is sourced from within Asian investors (1997 - 75.5%). According to China Daily, actual FDI increased by only 0.67% in 1998.
Common fear of currency deflation	o There is a fear of currency deflation in China among the international investment community. This threat not solely comes from lack of internal demand, but also due to chronic oversupply.
Threat intensified by accelerating unemployment	o Escalation in unemployment would heighten this threat if social unrest emerges. The authorities may seek to avoid social unread by currency deflation. Moreover, effectiveness of other tools (essentially the interest rates) for stimulating growth is in doubt.
Devaluation as a tool to aid SOE & banking reform	o We expect further interest rate cuts. But only devaluation will create the room in which SOE and bank sector reforms can proceed.
Political difficulty of painful economic choice	o The government is facing a devaluating dilemma: dangerously slow economic growth or a weaker currency. Faced with the alternatives, Renminbi devaluation appears to be inevitable.

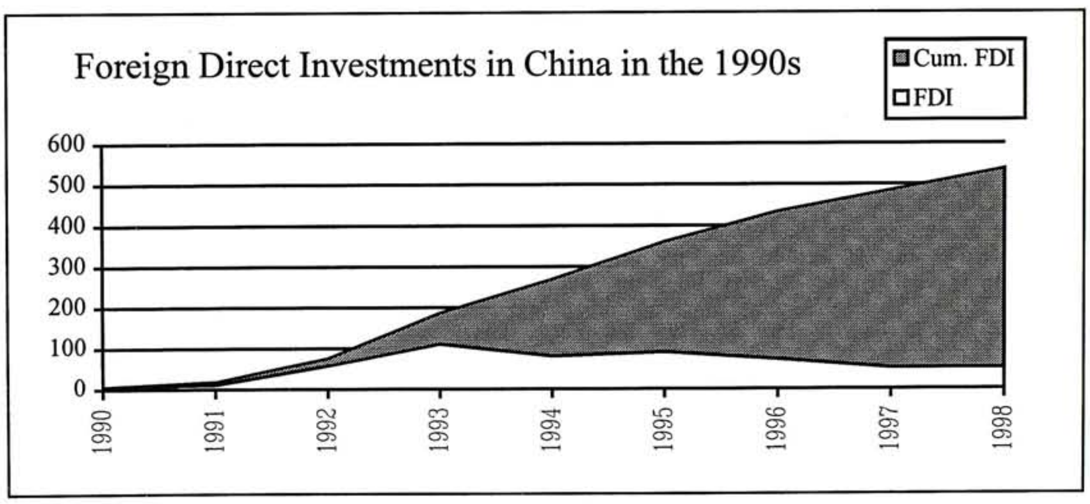
[2] Smyth, Philip & Neilson, Graham. "The Renminbi fall is inevitable".

Paribas Asian Equity Research. February 9, 1998.

In this vulnerable post-Crisis business environment, venture capitalists could provide valuable strategic advice and other value-added services to these enterprises. On a going-forward basis, the venture capitalists can

1. work together with entrepreneurs as a value-adding business partner,
2. bring additional diversity of management insights to the investee companies; and
3. to optimise the sourcing and application of expansion capital over time.

They could also provide the much-needed expansion capital to sustain China's economic growth. These venture capitalists and other foreign investors started tapping the Chinese market since 1980s and have injected vast financial resources and technical know-hows to improve the competitiveness of China..



Source: MOFTEC

The foreign direct investments in China increased only increased by an unsatisfactory 5.5% to US$24.2 billion during the first six months ended June 1998. (As a comparison, the 1997 foreign direct investment in China increased by an impressive 8.5% to US$51.7 billion when compared to that of 1996.) This can be due to the worsening cost-competitiveness of China to other developing countries, especially its Asia Pacific rivals in the post-Crisis arena.

The author, however, believes "buying into weakness, building the muscle during tough times" is the best strategy in preparation of fruition for the next economic upswing.

This report seeks to analyse the underlying drivers and growth factors of foreign direct investment in China which nourished the venture capital industry.

The main purposes of this report are,

1. Explore development history of venture capital industry and highlight their evolution in Asia Pacific.
2. Conduct a simple structural analysis on China venture capital industry, to look into drivers and inhabitants for the industry's growth in China.
3. Develop a set of critical success factors for venture capitalists tapping the China market.
4. Devise a road-map for the 21st century model venture capital investment house from the industry's China critical success factors.

Chapter 2

Methodology

Literature review and interviews are the basic methodology adopted & seek to cover:

1. the historical developments of the venture capital industry;
2. practical experience of venture capitalists tapping the China market;
3. lessons learned on making direct investments in China; and
4. other institutional factors that shape the industry's development.

Michael Porter's industrial analysis model will be used to guide the dissection of China venture capital industry peculiarities. Porter's models fits perfectly well in free-market economies characterised by minimal government & policy interventions. This is not the case for China and the author will propose refinements to compliment the Porter model in performing industry analysis for China venture capital industry.

The author will supplement and rationalise research findings by his own job-related knowledge and practical experience in the venture capital industry. The author would like to extend his warmest appreciation and gratitude to all his friends working directly or indirectly in the venture capital (direct investment) business and the securities sector. They shared valuable advice in refining the author's ideas as well as fine-tuning some industry-specific issues incorporated in this report.

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Chapter 3

Foreign Direct Investment in China

China remained relatively unexplored from the western economy prior to Deng's 1978 open door policy. Since 1979, the State Planning Commission promulgated various incentive measures to (1) attract foreign direct investment ("FDI") in light industry & outward processing operations, and (2) promote exports.

Foreign investors have since then painstakingly, and sometimes painfully, explored and tapped the China market. These foreign investors are now rethinking their strategies in a bid to keep up with intensifying competition in China's domestic market.

This chapter recaps ground-breaking milestones (including the 1990's National Industrial Policy Framework and 1995's Investment Catalogue) for FDI in China to let the readers acquire an adequate understanding on China's economic structure peculiarities and investment landscape. The author will touch a bit on the 9th Five-Year Plan which presented the central government's sketch for China's economic structural in the 21st century.

The author seeks to illustrate the institutional factors affecting the foreign investors investing into China. The same set of factors also shapes the model of how venture capitalists are doing business in China. This will serve as the foundation for the author's analysis of the China venture capital industry that follows in Chapter 4 and Chapter 6.

Running business and investment projects is nothing to do with "risk-elimination", it concerns "risk-management".

Managing risk is to reduce and mitigate **risks** *to tolerable level. China, a representative* emerging market, *is the battlefield for exercising such sophisticated risk-management skills.*

Overview

It is impossible to prepare an exhaustive list of considerations and decision criteria underlying entrepreneurs' overseas expansion motives. Knowing that China has been ranked consistently by the World Bank as the world's second largest recipient for foreign direct investments, the author recapped some 'basic' ideas below as a prelude to our forthcoming "East meets West story". This also serves to facilitate our subsequent analysis on China's competitiveness in attracting foreign direct investments:

East meets West Story	Attractions	Inhibitors
Overseas Expansion & Market Share	o emerging economies offers higher growth potential o utilise idle production capacity by penetrating untapped overseas market ahead of competitors	o political instability o different local business practices
Cost Competitiveness	o access to cheaper low labour costs and other factors of production o secure a new & steady supply of raw material	o higher management team expertise & staff turnover o lower labour quality and productivity
Establish overseas production base	o building new overseas start-of-art production facilities can be cheaper than upgrading existing plants at home o to reinforce globalisation of the enterprise and build distribution channels abroad	o investee countries may lack the infrastructure to support business growth (may be underdeveloped capital market, banking systems and legal enforcement)
Strategic Considerations	o well-charted global strategy in promoting global presence	o different standard of legal framework o cross-border tax and accounting compilations o uncertain currency risks

As we are moving towards a 21st century global marketplace, our economic hinterland, China, shall also be prepared to compete with other developing countries for international investment capital. Before moving to a dissection of "foreign direct investments in China", let's spare some time and take a look at the following table which captures the fundamental differences and similarities that mould investment sentiments in China and the Eastern bloc countries respectively:

Business Environment	China	East Europe Bloc ("ER")
Investment Stage and Investment Cycle	China is more developed with keen competition. Investment cycle typically within 3 - 10 years.	ER is in a less developed stage (say, currency convertibility) and investment cycle typically in order of 7 - 15 years
Free Market Orientation	Market dominated by (overseas) Chinese businessmen who are profit-conscious, supplemented by fractured SOEs.	Completely different mind-set. ER people are still learning the profit- and productivity-oriented mentality.
Management / Ownership	Chinese management philosophy tends to call for a stable management team. Early sign of emergence of locally grown entrepreneurs & conglomerates.	ER no established entrepreneur / family ownership structure. Enterprises are loosely owned by employees, management or privatisation funds.
	Investee management should pass through the following sharing test: Will they identify themselves with venture capitalists and share with them the investee company's - strategic direction and positioning - corporate business information - management & operations control, and - upside of business success	
Deal Sourcing (affected by ownership structure)	Asian families and wealthy individuals are increasing important source of deals.	ER is more complicated (individuals with established relations with SOE could be an important source of deals).
Overall Regulatory Business Framework	Chinese legal and enforcement system better developed.	ER legal system more gloomy & dark i.e. less transparent.

Business Environment	China	East Europe Bloc ("ER")
Political / Economic Factors	All are taking transitions from centrally planned economy to free market economy with China taking a prominent lead.	
	China perceived to be more politically stable (investing in Asia is considered more of a country risk rather than a regional risk).	ER being a carryover of 50 - 70 years' communist rule exhibited a general propensity to resist extensive changes and reform.
Information Flow	Both lack typical Western channels for obtaining information but China is on the lead when compare to ER. (Maintain business contacts and talking with local people seemed to be the optimal alternative in both cases.)	
Industry Growth / GDP Statistics	Domestic official statistics may be misleading and sometimes unable to capture all economic activities (due to existence of black / grey markets).	
Source of Capital and Growth Potential	China is known for its high saving rate & low overseas borrowings.	ER is less attractive in this regard.
Investment Realisation	Chinese securities markets are better defined with more *liquid* stock market. However, artificial market segmentation (A & B shares) can be a potential hazard to foreign investors.	ER must rely on trade sales (No LBOs, MBOs or IPOs for the time being.)

To have a better understanding on the decision criteria commonly adopted by institutional investors in evaluating an overseas expansion project, let's share a bit on how some of the region's renowned professional investment advisors think:

Emerging Market: Investment Rational & Concerns	Investment Rational	Investment Concerns	Investment Criteria
(Note [3]) N. Cross of 3i plc (UK)	o emerging & fast growing more-developed economies	o political stability o standard of legal framework not meeting investor expectation	Not mentioned
A. Holzapfel of Siemens AG (Germany)	o high growth potential when compared to the US/ European saturated market o relative cheaper labour cost	o less-stable economic & political development o increasing labour cost o complicated and less-transparent tax / legal system	o relation to authorities & market o management competence
Andrew Kim Sit of Kim Investments (US)	o for higher returns o more co-investment opportunities	o management team turnover	Not mentioned
C. Tuelings of Merifin (Europe)	o asset allocation guided by splendid growth potentials	o diverse market o complicated & fragile character	Not mentioned
T. Schwartz of Venture Capital Management (US)	o strong fundamentals of Asian economies compared to other emerging market (say, Latin America and Russia)	o experience of local investment profession o personal trust	o management competence o track record
C. Wimsett of West Midland (US)	o for potential higher capital growth & returns	o management team stability	o management competence o track record

Now we shall have grasped some basic ideas on determinants of foreign direct investments and we may move to track what China has done in the past and how well they were doing in attracting foreign direct investments to fuel the domestic economic growth.

[3] Asia Pacific Private Equity Conference, December 1995.

China Industrial Development & Invitation to Foreign Investors

Driving force for China's industrial development

China's industrialised development since 1980s are essentially result of the following changes in China's institutional factor: -

1. China remained relatively unexplored from the western economy prior to Deng's 1978 open door policy. With a diverse geographic territory and huge population, China's resources are remained undeveloped and unexplored.
2. With the introduction of "Open Door policy", China started compiling its "First Chapter" of foreign direct investments.
3. The emergence of business opportunities in the under-developed Chinese economy lead to a large influx of foreign investment, of which most are coming from Asia Pacific countries and overseas Chinese (and a majority of investments are channelled through Hong Kong).
4. Lots of Hong Kong businessmen brought with them management knowledge, manufacturing technology and expansion capital to invest in China. They pioneered and unleashed China's latent productivity as well as mobilised its workforce.
5. A significant portion of Hong Kong-based factories were relocated to or started setting up branch factories in coastal Guangdong province to make use of China's abundant and the then relatively cheaper labour, land and other natural resources.

Evolution of China's industrial policy

In light of the vast diversity in geographic area and regional cultural barriers (mind-set differences), a well-defined national industrial policy could be useful in guiding (not allocating) resources allocation for economic reform. Another Chinese structural peculiarity that naturally calls for a national-wide regulated industrial policy is its delicate social and economic balance which is too weak to withstand rapid reform or sudden influx of investment capitals and imported products.

The classic idea of "Four Modernisation" is too vague to be an effective policy-guiding tool for industrial development in China. The author thinks this idea at most serves only as a slogan. Instead of only paying lip-services to develop its economy, the Chinese government adopted many conductive policies to siphon foreign investment money.

To envisage how industrial policy can help smoothen the economic reform, we could start this by charting China's industrial development history.

China's industrial structure suffers a serious shortage of efficient infrastructure services as well as a scarcity of which China known as "Basic Industry (or Pillar Industry)" which essentially includes production inputs such as the raw material, fuel, energy and production equipment used by heavy industry.

Prior to 1979, a low level of investment in these sectors was caused mainly by (1) absence of capital and ineffective central planning as well as (2) unplanned allocation of government resources. Starting from 1979, the State Planning Commission introduced various measures (as part of the open door policy) to

1. Attract foreign investment in light industry & outward processing operations
2. Promoting exports
3. Decentralising trade and investments to the provincial level

This "Open Door" policy was well accepted with overwhelming success in its early years. However, the early success missed out adequate development of infrastructure services and pillar industries. During 1979 to 1993, industrial sector accounted for 52.8% of total foreign investments which investment in sectors such as transport, postal services, telecommunications and electric power industry accounted to only 1.6%. This created an economic development bottleneck.

Moreover, lack of co-ordination between national industrial and foreign investment policies led to repetitive imports of production equipment which were left idle and led to diseconomies of scale (as exemplified by China's automobile industry which suffered from over-capacity since 1990s).

China's Framework of National Industrial Policies in the 1990s

In 1992, the State Planning Commissions began researching a new industrial policy and announced in 1994, the "Framework of National Industrial Policies in the 1990s". This policy aims at building a solid industrial foundation for sustainable long-term economic growth and policy guidelines for foreign investment and economic management.

This policy has three distinct features:

1. Government policies are re-directed to cultivate pillar industries replacing the bias towards the southern and eastern coastal regions in general;
2. Attempts to direct and encourage foreign investments into bottleneck industrial sectors (such as transportation and energy sectors) as well as to the inner and western regions; and

3. Aims at improving the country's industrial structure by achieving economies of scale and co-ordinating the industrial policies of the different provinces.

To further strengthen the de-bottle-necking process and guide foreign investment capital and technology to less-developed industrial and services sectors, a Foreign Investment Catalogue was issued in June 1995 (and minor revision in January 1998). This provided a list of project areas which foreign investment is classified "encouraged", "restricted' or "prohibited" (with foreign investment generally "permitted" in projects which are not listed).

The 1998 revision reflected China's current economic planning policies and tied to approval procedure for foreign investment and preferential treatment. The 1998 new sector emphasis was advanced technology and development of key basic machinery and parts using new / advanced manufacturing technology.

China's Ninth Five Year Plan (1996-2000)

The State Planning Commission announced the following industries to be the preferentially developing sectors in the ninth Five-Year Plan ("FYP"):

1. Agriculture;
2. Pillar industries (infrastructure & basic industrial construction)
3. Light industries; and
4. Tertiary (service) industries.

During this FYP period, the State government will investment not less than US$1,000 billion with more than US$600 billion siphoned into aforementioned key national sectors.

In the agriculture field, the state will increase investment in construction of agricultural water conservancy facilities, promulgated regulations to protect the farmlands, develop agricultural technology to boost production output, consolidate fertiliser manufacturing industry, upgrade forestry and development of rural economy. State investment in agriculture sector will exceed US$34 billion.

Railway transportation capacity will be improved during the period. An integrated national-wide transportation network will also be established. For the telecommunication sector, the State will establish a national optical-fibre based telephone network. There are also aggressive plans to improve the urban telephone network by utilising digitised telephone exchange system and satellite communication techniques.

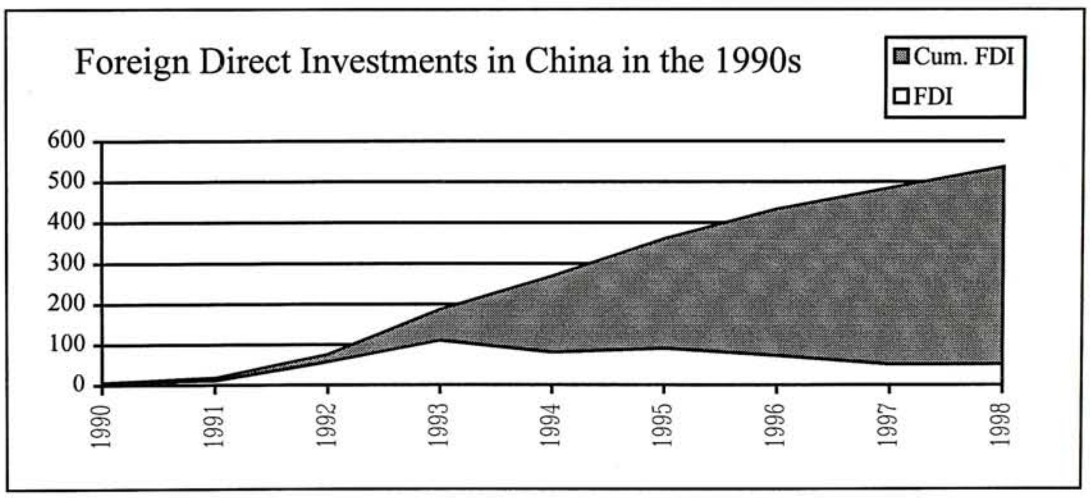
The State will allocate additional resources to enhance competitiveness of the nation's pillar industry. Additional government resources will be spared for the development and strengthening of machinery, electronic, petrochemical, automobile, architecture and construction material industries.

Light manufacturing industry will re-align its product structure, attain consistent product quality and re-engineer production process. As for the tertiary industry, the State will seek to strengthen regulatory framework for financial, insurance and real estate sectors.

The FYP is in fact an aggressive blue-print for China's national re-engineering project which sees to re-define and further develop the country's competitive advantages & core competency. The government will re-prioritise and spearhead its financial and other resources to refuel the economic growth momentum. The most important part of the FYP is a co-ordinated country-wide re-deployment of resources and efforts to fortify its economic structure and set up a platform for China's march into the 21st century marketplace.

Declining Attraction to Foreign Investors?

Since the Open Door Policy in the 1980s, China exhibited phenomenal success in drawing foreign direct investments. Such investments mainly from Hong Kong / Taiwan and increasing from other Asian countries as well as US and Europe. This greatly improved the China domestic economic structure and efficiency and fuelled China's tremendous GDP growth in recent years.



Source: MOFTEC

To maintain China's attractiveness to FDI amid increasing competition from other developing countries, especially in the post-Crisis arena, China need to further improve its investment climate.

It is undeniable that triggering factor drawing this huge foreign direct investment in the early 1980s is China's cost competitiveness. Nowadays, China is gradually losing its lustre in cost competitiveness to other developing countries. However, China can still leverage its position of having a vast domestic market which has been predominately untapped by foreign products.

"AT Kearney" and "Business China"[4] conducted a Survey in 1998 and identified that 69% of foreign corporations making direct investments in China already based on "revenue factors" (i.e. the magnificent China and Asian Pacific market). The remaining 31% corporations are having their China direct investments initiatives driven by "cost factors" (i.e. lower labour costs and abundant supply of raw material).

Cooling of the China Mania

China is losing its cost-leadership to other developing countries. The foreign direct investment in China, after reaching its peak in early 1990s, appears to losing its growth momentum. Since 1985, the contracted FDI in China is diminishing gradually and the early-90s China Fever is cooling down apparently.

The author believe such "cooling" is partly come from China's deliberate strive to regulate the massive influx of foreign investments in order to control its rising inflation in the early 1990s. The 1994 national-wide austerity program characterised by a series credit-tightening procedures and implementation of new tax

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[4] "The Path to Profit". Business China June 8, 1998: 1-3.

regulations to discourage speculative foreign (as well as domestic) investments in China's then overheat real estate sectors.

The most important and positive result after the China-boom "*cooling*" is the improvement in investment quality. In light of the decline growth in foreign direct investment to China, the conventional wisdom claiming the loss of investors' interest in China may not be conclusive. The investment made by large multinational corporations (say, the Fortune 500 companies and other niche market leaders) to China has never been stopped. We can see the big household names like chemical leaders Amoco, Exxon, Rohm & Haas, Rhone Poulenc, BASF, retail giants Makor, Carrefour, Wal-Mart, and other international household names such as American Standard, Glaxo, Pirelli, and Lafarge all established their presence in China.

Despite a recent decrease in foreign direct investment, this China mania is still evidenced by the increase in the "average size of an FDI contract". During the earlier days (from 1990 to 1994), the size per foreign investment project is US$1.3 million while that in the later stage (from 1995 onwards) increased to US$2.6 million. The author believes the foreign investors have becoming more cautious and more organised in tapping the China market. They endeavour to demonstrate their long-term commitment to building a market presence in China and Asia. The foreign investors are no longer small-to-medium size firms attracted to China by its low-cost factors of production. The foreign investors are prepared to have a long-term warfare and make themselves ready for competition in the 21st century global marketplace.

Average Size of FDI Contract (1990 - June 1998)

		(USD million)	
Year	No. of Contracts	Contracted Value	Value per contract
1990	7,200	6,600	0.92
1991	12,900	11,900	0.92
1992	48,700	58,100	1.19
1993	83,400	111,400	1.34
1994	47,500	81,400	1.71
1995	37,000	91,300	2.46
1996	24,500	73,200	2.98
1997	21,000	51,800	2.47
1998 *	9,600	24,200	2.52

Source: MOFTEC
* 1998 figure is six-month figure ending June 1998

The declining FDI growth also implied less investment projects are concluded in a hasty manner without commissioning adequate feasibility studies as in the early 1990s. Undisclosed source from MOFTEC in Beijing indicated many FDI contracts entered into in the heydays of early 1990s have never been realised. The contracting parties are just unable to enforce such contracts for fundamental problems including inadequate financial resources, undesirable domestic cost structure and unanswered doubts on product acceptability, all these are fundamental problems which can be avoided by conducting some basic pre-acquisition due diligence.

Investment Rationale and Concerns for China Direct Investments

The 1998 AT Kearney / Business China reported the top five priorities and top five constraints affecting profitability in China are: (Percentage in bracket indicates percentage of survey respondents ranking this element “top five concerns” in their response.)

Investors Concerns for China Direct Investment	
Top Five Priorities	Top Five Constraints
• Employee development / management localisation (72%)	• Intensified price competition (69%)
• Improve distribution systems / customer access (61%)	• Lack of quality local management (67%)
• Strengthen management control (58%)	• Weaker than expected market growth (59%)
• Capture greater market share (43%)	• Increasing competitive environment (52%)
• Improve management quality (42%)	• Deteriorating accounts receivable issue (46%)

The Paradigm Change for China Direct Investment

Another interesting finding revealed by this survey is a "paradigm shift".

When foreign investors started tapping the China market since 1978, they place much emphasis on choosing a domestic JV partner. The forces driving this mentality are:

1. foreign firms have limited legal right to own property and employ local staff,
2. lack of a mature legal system to deal with contractual agreements; and
3. bureaucratic swamp the foreign investors must beat when starting business in China.

The last two reason encourage firms to join forces with a partner who make use of their political power as well as economic power. Other reasons calling for having a Chinese partner is for better access to market, local know-how & know-who (Guanxi).

However, some fundamental cultural differences existing between the joint venture partners. Some of these fundamental differences include:

	Chinese System	Western System
Business objective	o "productive efficiency"	o profitability
Budget	o planning and authorisation	o performance evaluation motivation
Financial reporting	o report to government (e.g. tax & planning bureau) and central planning agencies	o protect minority shareholders / creditors
Management Accounting	o simple & ignored by mainstream accountants	o an important accounting field

Due to the cultural differences and sometime, hidden agenda of the joint venture partners, we see a declining popularity of using JV as a PRC investment vehicle. We saw JV's share within total FIE approvals decline from 77% in 1993 to 55% in 1997 while that for WFOE increased from 23% in 1993 to 45% in 1997.

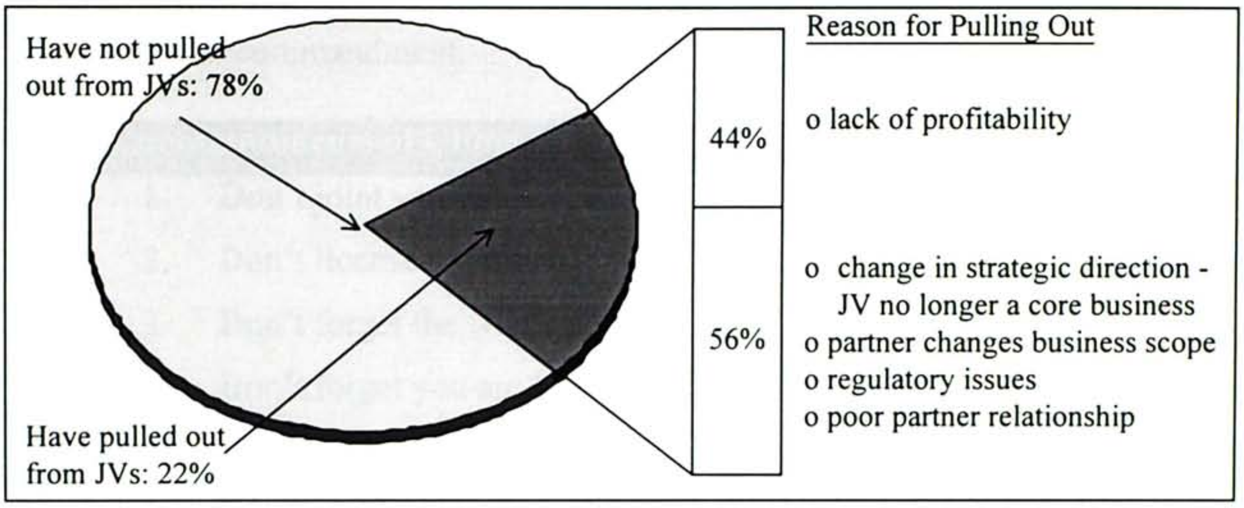
New FIE Approvals

		% of FIE Approval	
Year	Total FIE	WFOE	JV
1991	12,900	21%	79%
1992	48,700	18%	82%
1993	83,400	28%	77%
1994	47,500	27%	73%
1995	37,000	32%	68%
1996	24,500	37%	63%
1997	21,000	45%	55%

Source: MOFTEC

Key
FIE Foreign-invested enterprise
WFOE Wholly Foreign Owned Enterprise
JV Sino-Foreign Joint Ventures

This is further illustrated by the A T Kearney 1998 China Survey which revealed more than 60% of the WFOE enterprise are profitable while only 40% of JVs are profitable in 1997. This same research also revealed, somewhat startling, past experience of foreign investors dealing with their local partners. As many as 22% of the survey respondent indicated that they have pulled from at least one Sin-foreign joint venture co-investment projects.



The author believes the foreign investors are more willing to be "on their own" in tapping the Chinese domestic market as the rule of game has became more "impersonal" as exemplified by

1. more levelled playing field for the foreign investors (and domestic players as well) in terms of government intervention and industrial policy;
2. more transparent and predictable legal (and legal enforcement) system. We also see a more consistent government policies and more open government technocratic who are willing to exchange ideas and reach consensus with foreign investors;
3. both the local and foreign business players have become more willing to listen to each other and align their difference; and
4. after opening of the "China market" for two decades, we see emergence of the first batch of seasoned China locally brought-up business executives who could effectively bridge the difference in China and foreign business practices

This idea is also shared by a number of professional advisors. "*Thou shall not joint venture*, ... !" warned Charles Stevens, a partner of leading U. S. law firm Freshfields, at the November 1997 Asian M&A Forum.

During this seminar, Stevens even proposed his " Ten Commandments of China Direct Investment" with "Don't' Joint Venture" as the utmost important and fundamental commandment.

Ten Commandments of China Direct Investment

1. Don't joint venture.
2. Don't license too much.
3. Don't forget the whole picture.
4. Don't forget you are foreign.
5. Don't bribe.
6. Don't employ forever.
7. Don't forget to audit.
8. Don't evade taxes.
9. Don't neglect language difficulties.
10. Don't ignore the local courts.

Source: Charles Stevens, Partner, Freshfields. 1997.

Stevens holds a strong negative attitude towards entering into a joint venture agreement with a local partner who is actually a competitor in the field. If one must joint venture, Stevens stressed the importance of not so doing permanently or sincerely. Entering into a joint venture with a competitor is a very long-term commitment. If one is unfortunate enough to make such a commitment, make sure that the co-operation documents allow re-evaluate of this commitment once every five or ten years. He also warned foreign investors to think of escape and consider joint ventures, at best, like a temporary marriage with a strong pre-nuptial agreement.

In terms of managing relationship with Chinese joint venture partners, some of Steven's suggestions are quire inspirational. He advised foreign investors "not to forget the whole picture". In China, joint venture partners usually have affiliations with other companies dealing in such things as raw materials, distribution contracts and financing services. The foreign investments are actually a way of taking out profit from these areas. He explicitly warned foreign investors to look out for hidden agenda for the domestic joint venture partners.

How to Maintain China's Competitiveness to Foreign Investors

The author believes if China have to maintain its competitiveness in the 21st century battle for foreign investments, it should improve the following institutional factors

1. maintain a stable economic and political environment,
2. offer a favourable operating condition and business environment, and
3. post a transparent government policy
4. eliminate government involvement in commercial sector

If China can successfully improving its attractiveness in these areas, it could stand a far better chance to secure additional foreign direct environment. The author recaps the important milestones for these changes in institutional factor and briefly commented their importance in sustaining foreign investments.

1. Stable Economic and Political Environment

The influx of FDI to China, apart from fuelling economic growth, also created a platform for the China government to introduce various revolutionary reforms on, say, SOEs, taxation, banking system, legal and regulatory framework, securities market, and foreign exchange systems. All these constitute a more efficient playing field for both the foreign investors as well as domestic corporations.

A number of these reforms are well received by the market and stood with tremendous progress and success while other are still underway and may encounter massive resistance and problems.

Some of these more successful and prominent reforms include:

Legal Services

The Chinese government takes a cautious approach in opening the domestic legal services sector to foreign investors. Since 1992, there are 15 cities where foreign law firms are allowed to set-up offices. As of end of 1998, 93 foreign law firms have already built their outposts in these 15 Chinese cities. The Chinese government, however, forbids these Chinese law firms from employing domestic lawyers or furnishing legal opinions for Chinese statue laws and regulations[5].

[5] "China Service Industry ". China Trade Post September, 1998: 6.

Taxation & Accounting

To track the results of numerous taxation and accounting reforms in China, the following table is prepared

Year	Milestones
Pre-1985 stage	"*Fund accounting*" financial reporting framework as adopted from the classic Soviet system.
1985	Adoption of the Accounting Regulation for the PRC Sino-Foreign Joint Ventures.
1988	Formation of China Institute of Certified Public Accounts. A task force team is also formed in the Ministry of Finance to oversee the development of PRC accounting standards.
1991	The first PRC exposure draft of "Accounting Standards for Business entities No. 1" was released by the Ministry of Finance.
1992	The Accounting Regulations for Joint Stock Limited Liabilities Companies became effective in January 1, 1992. The Accounting Regulations for FIEs also became effective since July 1992.
	The Big-Six International CPA Firms were allowed to form contractual joint ventures with Chinese local CPA firms and establish offices in China.
1993	The Enterprise Accounting Standards became mandatory in July 1, 1993.
	(Before then, Deloitte Touche Tomatsu International secured the US$3 million consultancy contract from Ministry of Finance to assist the development of the first-ever PRC GAAP. Various exposure drafts for PRC GAAP were released between 1994 - 1996.)
	The China Law of Certified Public Accountants was adopted by the National People's Congress in October 31, 1993. Later in December 29, 1993, the China Law of Accounting was also adopted.
1994	PRC Tax system reform being implemented in 1994 and the China Law of Auditing was also adopted by the National People's Congress.
	Another significant milestone, the China's first Companies Law become effective in July 1, 1994.

1995 - 1996	Not less than 4 international accounting forums were held in Beijing to review the 30 exposure drafts for the PRC GAAP. From January 1, 1996, the ten PRC Auditing Standards as issued by Ministry of Finance became mandatory.
1997 - 1998	The China's home-grown Auditing Standards are being promulgated and additional Chinese accounting standards announced. As of October 1998, there are 8 announced accounting standards.
	As of end of 1998, there are more than 20 international CPA firms operating affiliated offices in China.

The Chinese government demonstrated vigorous efforts in strengthening its regulatory financial reporting system in response to continuous influx of foreign investment capitals.

Securities Market

Shanghai Stock Exchange was officially re-opened for securities dealing in December 1990. This marked the first step in revitalising China's securities and capital markets. This was followed by the July 1991 official opening of the Shenzhen Stock Exchange. Formation of the two exchanges successfully preceded the opening of PRC domestic securities market to foreign investors in a separate board, the B shares. The fist B-shares, Shanghai Vacuum, was listed in the Shanghai Stock Exchange in December 1991.

To institutionalise the government's efforts to regulate the securities market, the China Securities Regulatory Commission (the "CSRC") was set-up in 1992 and published a number of disclosure requirements for listed companies since then.

Together with the People's Bank of China and the State Council Securities Committee, they have been China's securities market watchdog since then[6].

As of end of 1998, China has established five listed & close-ended fund-management company having "asset under management" of Renminbi 2 billion each. It was well recognised that Chinese government's introduction of investment funds signifies its determination to develop a base of institutional investors to smoothen future developments of the fledgling domestic securities markets.

A very significant breakthrough in the China domestic securities market regulation is the introduction of the concept of "minority protection". Despite the implementation of this concept in China is still at its early stage, much encouraging milestones have been shown in the China companies law, securities laws and domestic listing rules. Foreign investor participation (or the Chinese government's desire to draw foreign investment capital) should be a key element in catalysing these positive changes. The author also believes having China domestics companies to participate in cross-border securities activities is another catalyst for the introduction of "minority protection" in China. (Please refer to Appendix I of this chapter for a brief list of "Pioneering Chinese Issuers of International Equity")

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[6] The government endorsed a plan to merge the State Council Securities Committee and China Securities Regulatory Commission, sidelining the People's Bank of China and forming China's first unified securities market regulator.

Banking Industry

China's domestic banking sector, being foundation of the country's finance sector, has long been insulated from foreign competition. The government's direct involvement in domestic banking operations rendered this a strict monopoly. The first milestone change to the Chinese banking industry crystallised in 1985 when doors were opened to foreign banks to set-up their headquarters, branches and Sine-foreign joint-venture banks in the special economic zones. Before then, there were only four foreign banks allowed to set-up a branch in China (they are the Hong Kong Bank, Standard Chartered Bank, Bank of East Asia and Overseas Chinese Bank). However, NO foreign bank is allowed to engage in retail banking and Renminbi businesses.

The banking industry overhaul in China can be dated back to 1993 when the People's Bank of China abandoned its lending businesses and restructured into China's home-grown central bank. This is China's first ever banking regulator which paved the road for future banking reforms.

This also accompanied by Chinese government's 1994 initiates of unifying the then two-tier currency system and formation of three new policy banks[7] thus transforming existing state "Big-Four" banks[8] into full-fledged commercial banks.

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[7] The three policy banks formed in 1994 are (1) State Development Bank of China, (2) Agriculture Development Bank of China and (3) Export-Import Credit Bank of China.

[8] The "Big-Four Banks" are Bank of China, Industrial and Commercial Bank of China, Agriculture Bank of China and Construction Bank of China who collectively account for more than 90% of China's domestic banking assets.

The real challenge to domestic banking industry did not realise until late 1996. During late 1996 and early 1997, eight foreign banks[9] are allowed to handle Renminbi transactions in Shanghai's Pudong New Area. The real impact to the domestic banking sector is only minimal taking into account the trivial volume of Renminbi business thus generated[10]. This was, however, a significant move that indicated Chinese government's solid intention to open up the domestic banking sector. A healthy Chinese domestic banking sector could serve as a platform to catapult the State-Owned Enterprise reform by providing the necessary expansion capital.

2. Favourable Operating Condition

The government also makes a number of efforts in improving the overall investment climate. The government make extensive investment to improve and upgrade the country's infrastructure system (including transportation, and telecommunication) to improve the overall operating efficiency of business entities.

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[9] The eight foreign banks are (1) Bank of Tokyo-Mitsubishi, (2) Citibank, (3) Dai-ichi Kangyo Bank, (4) Hong Kong Bank, (5) Industrial Bank of Japan, (6) International Bank of Paris, (7) Sanwa Bank, and (8) Standard Chartered Bank.

[10] During an interview with Mr. John Beeman, Country Corporate Office of Citibank - China on April 24, 1998, Mr. Beeman mentioned that after twelve months of opening up Renminbi business to nine foreign banks, the aggregate Renminbi loans and deposits from and to foreign banks amounted only to RMB 519 million and 566 million respectively. This means foreign banks account for less than 0.005% of the total Renminbi assets which is total insignificant.

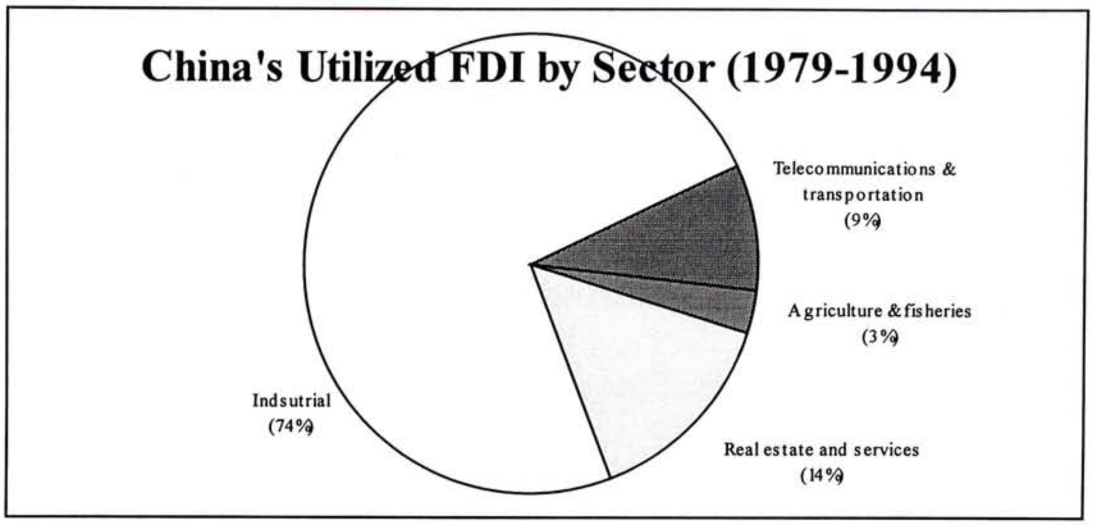
(Please refer to following section on China's Ninth Five-Year Plan for additional details.)

The other major difficulty that hampers business development is the lack of local credit and funds. The Chinese government is vigilant towards the control of money supply and FIEs (as well as other non-privileged domestic borrowers and enterprises) are having raising difficulty in raising financing to fund their local expansions and operations. In these regards, venture capitalists can help to alleviate this capital shortage.

3. Transparent Government Policy

To boost foreign investments and let the investors fully understand the allowable scope of business, a transparent government policy on foreign direct investments is essential.

In the past, foreign investors do not know what is their allowed business scope within Chinas highly regulated business environment. Foreign investments are thus mainly siphoned to manufacturing sectors where government policy is more transparent. We can see this trend from the following analysis:



Source: MOFTEC

The most important step in shaping the increasing policy transparency was made in June 1995. The Chinese government issued a set of national guideline on foreign investment which lay out specifically, and for the first time in the Chinese history, a legal boundary between what is encouraged, restricted and prohibited from foreign participation.

This is the second milestone in shaping China's national industrial policy to direct foreign capital to sectors where less-efficient production capability exists. Foreign investors are also encouraged to invest in the central and western China where development of these inland provinces lags behind their coastal counterparts.

On top of this, the guidelines also opened legitimise new frontiers for foreign investors. First ever in China's stated government policy, green-lights to foreign participation in areas such as nuclear power stations, civil airports and mass transit railway is now officially on. For protection of national interest, however, the Chinese government reserves majority shareholding in these projects.

This guideline also explicitly "*proclaims*" Chinas strategy on utilising FDI to bridge the economical gap and social needs for China. It was widely recognised that the Chinese government would like to encourage (1) construction of energy and transportation infrastructures which experience gross under-supply and (2) foreign investments in the less-developed central and western part of China. The ultimate goal of the guideline is to effect a economic de-bottlenecking to ease the country's capacity constraint and further development hurdle resulting from inadequate and fragmented infrastructure and staggered regional development gasp and income disparity between the coastal and inland provinces.

This guideline worked by providing a list of explicate definition of encouraged", "restricted" and "prohibited" investment for foreign investors and detailed such classification in a "catalogue guiding foreign direct investments". For "encouraged" or other allowable investment activities with project size not exceeding US$30 million, the coastal provinces, municipal cities, autonomous regions are allowed to examine and grant investment approvals to proposed foreign invested projects.

4. Disintegration of Government Political and Business Interests.

Another important milestone is the Chinese governments stated policy to disassociate government ministries (and other government agencies) from political and business interests. This is exemplified by the 1998 government decree to disengage the People's Liberation Army ("PLA") and other armed-forces from commercial activities before end of 1998. The PLA managed to attain this stated target on December 15, 1998 [11]. (See the text box on 999 Group which illustrated PLA's effort in fulfilling this government decree.)

<u>Disintegration of Political and Business Interests</u>

With response to a government decree, effective December 15, 1998, the 999 Pharmaceutical Group ("999 Group") was disintegrated form the PLA and held themselves accountable to the State Council.

The 999 Group was a PLA-sponsored profit-oriented business entity and its principal operations falls under the umbrella of Southern Pharmaceutical Factory which, directly or indirectly, owns more than 100 affiliated companies spanning across Asia Pacific and even Russia. This is a diversified business group with 1997 net profit of Renminbi 400 million and has actively seeking expansion through an aggressive merger and acquisition program.

The 999 Group commenced operation in 1986 with a Renminbi 5 million bank loan granted to PLA and have grown to become a leading Chinese conglomerate of diversified business interest with net assets exceeding Renminbi 3.8 billion.

Hand-over of this high-profile and well-known Chinese conglomerate from PLA to the State Council was a ground-breaking event that demonstrated the government's commitment to rationalise the domestic commercial market.

Historically, the PLA is an influential organisation in the Chinese government set-up. Apart from a powerful armed force, PLA also has its own representative in the State Council and operates numerous business activities under the PLA umbrella and

[11] "No more business activities for China's armed forces". <u>China Economic News</u> (a Chinese newspaper published in China). December 15, 1998.

have been influential both in the political and commercial arena. By rationalising and fracturing this long-established status quo, the government fully demonstrated its commitment to rationalise the domestic business environment. This shall be a significant breakthrough in establishing a level playground for foreign investors in China. In the past, it was not uncommon for PLA (and other government agencies) to abuse their superior government connections and power to benefit their business operations.

Earlier in 1998, the Chinese government also promulgated an order to restructure[12], mainly through "privatisation" (or "corporatisation") of government ministries to

1. streamline the government operations,
2. liberalise the market by reducing government involvement in business activities, and
3. avoid conflict of interest for government ministries operating a profit-seeking business.

In the past, foreign investors operating in China are in an unfavourable position as they need to deal with their government / statutory regulators who also owns business interests in the same field in which they are operating. This regulator sets the rule of game, supplies raw material to or purchase end product from this

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[12] According to this government decree, 15 ministries (including Ministry of Electric Power, Ministry of Internal Trade, State Commission for Economic Restructuring) will be abolished, 4 new ministries (including Ministry of State Land Resources and Ministry of Information Industry) will be established, with 3 other existing ministries re-named.

foreign-invested enterprise AND compete with it for business and market share. (See the following text box for further illustration on this.)

<u>Conflict of interest to decline</u> (reduced government multiple-level involvement)

Until 1998, the PRC power industry was principally regulated by the Ministry of Electric Power ("MOEP") which prepare sketches China's blueprint in developing its power generation network, setting performance goals and safety standard for power plants as well as other regulatory requirements. Under this unique Chinese regulatory framework, the MOEP demonstrated a multiple-level involvement in the PRC power sectors, namely (a) industry regulator, (b) power generator (competing with foreign-invested independent power producing plants), and (c) sole operator of the nation's power distribution networks.

The early-1998 dismantling of the MOEP and the new China State Power Corporation ("CSPC") gives a new page to the PC power industry by separating the regulatory function from the operational function and brings in market competition to reduce conflict of interests arising from MOEP's multiple-level involvement. The State Development and Planning Commission has become the sole regulatory agency with authority to approve on-grid tariff and new power plant projects. The CSPC become a commercial body responsible for owning, operating and managing all state-owned power plants and the power distribution network. Although all new projects and tariff increase application still need to be discussed and filed with the CSPC and then submitted to the SDPC for approval through the CSPC, the CSPC no longer has any approval authority.

This is generally perceived to be a positive move to the development of the Chinese power industry by reducing the opportunities for conflicting interests to develop.

Under a planned market economy system for several decades, the march into open market operation could be painful and difficult. It's heartening to know that the paradigm has been changed among the government officials who understand and to the point of fulfilment, that a market-force based and level business playground is the foundation to attract foreign direct investments.

The Roads Ahead for China

Some leading economists and sociologists proposed the following 10 salient economic and social characteristics[13] which they believe shall chart-out the roads ahead for China.

They believe amidst the proven tremendous growth potential of China, certain risks are inherent and the immediate concerns are

1. completion of China's economic structural reform,
2. China's integration with the global economic system, and
3. how effective is Chinese government in sustaining its economic growth.

They advocated the following 10 salient Chinese features upon which China's home-grown economic development model shall be cultivated are:

(1) The 15th People's Congress' reaffirmation of Deng Xiaoping's reform strategy which serve to provide a conceptual framework to guide economic reforms.

(2) China is undergoing a smooth development (the soft landing) given a current stable level of commodity and foodstuff price. This gives government additional time to strengthen China's fragmented and vulnerable, yet important, agriculture system.

[13] "The Prospect of China". Hong Kong Economic Monthly Journal. Vol. 248. November 1997: 20 - 24

(3) Strengthening security markets regulation to sustain market creditability and improved risk management. The most challenging part of this package shall be the reform of China's debt-ridden state-owned banking sector.

(4) Further growth of foreign reserve could stabilise the RMB exchange rate and provide a stable economic environment to nurture economic growth.

(5) Rising unemployment shall be properly handled to facilitate massive and fundamental SOE reform,

(6) "Corruption" and "Monopoly" hinders market transformation and potentially threatens social stability.

(7) Structural problem in the consumer market and the inability of financial intermediaries to provide "storage of value" to general public. This hinders the ability of siphoning personal savings to capital investments.

(8) Environmental and population problem can drag China's future economic growth.

(9) Reunification of HK with China can further propel China's economic and political reform and improve China's standing in the international political arena.

(10) China's long-term development is risk-prone and this is a matter of exploiting China's 7 growth drivers:

1. continuous development of the agricultural sector,
2. wealth creation resulting from China's structural reform,
3. efficient utilisation of foreign direct investments and exchange reserve
4. increased productivity due to adopting of latest manufacturing techniques and improved level of education,
5. mobilisation of idle rural work-force provide a low-cost quality work force to maintain China's international competitiveness,

6. broadening of China's economic structure, and
7. reduced economic volatility as the economy matures.

These growth factors, however, could only be directed to meaningful economic growth upon successful attainment of

1. eradication of corruption,
2. substantiation of market reform and regulation,
3. economic transformation in the absence of severe environmental problem,
4. elimination of social unrest and undue credit plunge, and
5. stable global economy which provides a platform for China's economic transformation.

From the perceptive of a financial investor making strategic investment in China, the author considers the following set of growth accelerators and inhabitants shall determine China's competitiveness in attracting foreign direct investment and shape the direction of its economic development:

Where China is Going?!

Growth Accelerators	Growth Inhibitants
Re-organisation of government structure (and economic involvement via SOE reform) promote productivity, eliminate bureaucracy & unnecessary political intervention (as well as corruption).	State-Own Enterprise ("SOE") reform brings extensive unemployment problem that undermines economic stability and demolishes the platform for further economic reform.
Breakthrough of ownership / capital structure reform which nurtures capital market development and strengthens security market regulation.	Government financial resources and foreign capital not adequate to ease financial burden for China's large-scale SOE reform & chokes the infrastructure investment.
Increased industrialisation (especially in the less-developed rural areas) unleashes idle capacity and mobilises latent work force.	Income disparity & uneven development between coastal and inland provinces may cause conflicts and destructive competition among provinces.
Government and overseas investments in infrastructure improve internal competitiveness which, in turn, fortify domestic economic structure.	Social security, medical and housing reforms that goes hand-in-hand with the economic structure changes may invite eruption of abrupt disruption and brings about social unrest in both urban and rural areas.
Continuous influx of foreign direct investment fuels development of domestic economy and enhance market efficiency / productivity.	Accentuating population growth and fractured education system worsen labour quality and dampen the economy's strive to improve production efficiency, thus hurting the foreign investors.

We could see from the above grid (as proposed by the author) that every coin has two sides.

The Chinese government undertakes bold and unprecedented structural reforms to build a solid domestic economic platform in the hope of escorting China into the 21st century global marketplace. All such reforms will bring about a short-term or medium-term painful social side-effects. These reforms also demand substantial financial as well as government resources to implement. Failures of any of these reforms will definitely be devastating.

This is, in effect, a function of Chinese government's successfulness in

1. Implementing the various structural reforms (in capital market and legal systems) without triggering social unrest
2. Improving and attaining a balanced development of coastal & inner region which fortifies the country's overall efficiency in infrastructure
3. Illuminating government red-tapes and dissociating government from business activities. This will let the market attain its natural equilibrium.
4. Unleashing latent work-force and properly channelling the mass populace into productive economic sectors.
5. Attracting and channelling foreign direct investment and fuelling this financial resources to support China's structural reforms.

China's WTO Entry

Despite China's WTO entry will only be crystallised after satisfactorily completion of China's negotiation campaign with all 134 TWO members, we all see the momentum of China's strive to WTO entry! After Premier Zhu Rongji's April 1999 US visit and consequential perception of China's more willingness to open up its market[14], China's WTO entry appears to be more imminent than any time in history!

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[14] Say China's April 1999 proposal of allowing foreign equity ownership to own not more than 35% in China's domestic telecommunication companies as well as the long-awaited liberation of domestic RMB business to all foreign banks within a 5-year period. (Please see next section for further details.)

The WTO entry could anchor China's influence in the global economy as well as attaining a more secured access to export markets and increased flow of foreign direct investments. All such impacts could bring magnificent long-term growth potential to the Chinese economy. This growth momentum is much in need during this period of stagnant domestic economic growth.

Of curse, all successes come with a price tag! The WTO entry may give rise to fierce competition in the domestic market after lifting government protective measures (generally favouring domestic companies). This could catalyst the demise of China's injured state-own enterprises. (As well as the domestic banking sector - see below for further elaboration.)

The most important impact to China upon the WTO entry should be its improved position to build-up a multi-facet and multi-lateral platform for China to handle cross-border trade disputes and discussions. China's chance of being caught and hard-hit by protectionist measures in China's export market are make more remote. This could be illustrated by China's more-secured access to the US market. US generally grants the "Most Favoured Nation[15]" ("MFN") status to the WTO members. Instead of undergoing an annual review, China's may then secure a permanent MFN status and assure its access to the US market. Similar situations could be seen for China's access to other overseas markets.

[15] Now renamed as "Normal Trade Relations".

Most of the after-WTO entry tariff and market opening will take place in phases extending over a considerable period of time, hence there shall only be minimal immediate impact on China. The author believes it will take three to five years for the WTO entry impact to surface -- some of these impacts may be negative. Improved trade prospect, domestic economic efficiency and influx of foreign expansion capital, however, shall benefit China in the long-term.

China's World Trade Organisation market access concessions

China's WTO accession represents an opportunity to "address" a broad range of unfair trade practices, trade barriers, discriminatory regulatory processes, lack of transparency, and other policies which limit foreign participation in the Chinese market or unfairly affect foreign trade. The broad set of commitments China has offered, and the substantial negotiations which remain to be held, will advance foreign investors' business interests in a fundamental way and make China move towards internationally-accepted standards of business conduct.

Broadly speaking, the market access commitments China has offered thus far will bring China at or above existing WTO standards on issues and sectors of major concern to the foreign (in particular the US) investors. These commitments include further opening up of the domestic service sectors which cover the broad range of sectors, including distribution, value-added telecommunications, insurance, computer and business services, environmental services, franchising and direct sales, legal and accounting, sound recordings, and entertainment software. These concessions are:

Sector	Agreement and timing
AGRICULTURE	Average agricultural tariff will fall to 17%. Tariffs on "US priority products" to fall even further to 14.5%. China has also agreed to cancel its ban on certain wheat, citrus fruit and meat imports from the US. All tariff reductions to be phased in by 2004. The lifting of the ban on wheat, fruit and meat imports is effective immediately.
INDUSTRY	Average industrial tariff 9.4% (from 24.6% in 1997); 7.1% for US priority products (including autos, chemicals and information technology). Two- thirds of tariff reductions phased in by 2003; the remainder by 2005 with a few exceptions.
Automotive	Tariffs on autos will be lowered to 25% from 80%- 100% at present. Average tariff on auto parts to fall to 10%. Auto import quotas to be abolished. All by 2005.
Chemicals	China to reduce tariffs on 70% of all imported chemicals to 5.5-6.5% from 35% at present.
Information technology	China will reduce tariffs on IT products including semiconductors, computers, computer equipment and telecommunications to zero from an average of 13.3% at present. Most IT tariffs eliminated by 2003; remainder by 2005.
SERVICES	
Audio-visual	Still under discussion. But China will allow 49% foreign ownership of video and sound recording distribution. Foreign majority ownership of cinemas permitted within 3 years of accession
Banking and securities	Still under discussion
SERVICES	China today is among the markets most closed to services exports anywhere in the world. Such concessions include Chinese accession to the two major existing multilateral service agreements on basic telecommunications and financial services.
Distribution	US firms to be allowed full trading and distribution rights within 3 years of accession for most products (within five for fertilisers, crude oil and processed petroleum products). * Including direct sales, maintenance, retailing, transportation, wholesaling and all auxiliary services

Sector	Agreement and timing
Insurance	Foreign property and casualty firms to be allowed to insure large-scale risks nation-wide upon accession with all geographic restrictions phased out within 5 years of accession (and within 2-3 years in key cities). Foreign insurers allowed to conduct group, health and pension services within 5 years. 50% foreign ownership of life insurance JVs upon accession and 51% within 1 year. 51% foreign ownership of non-life and reinsurance JVs upon accession and wholly-owned subsidiaries within 2 years.
Professional services	China to allow foreign majority ownership of accounting, architecture, computer-related, dental, engineering, legal (Chinese law excepted), management consultancy, medical, taxation and urban planning services.
Telecom-munications	Geographic restrictions to be eliminated on services including paging (within 4 years of accession), value added (4 years), mobile (5 years) and fixed-line (6 years). China will also allow 49% foreign investment in all services (within 4 years of accession) and 51% in value- added and paging (4 years).
Travel and tourism	Majority foreign hotel ownership upon accession and 100% within 3 years of accession. No restrictions on foreign operation of all travel agency services.
QUOTAS	All quotas and non-tariff measures to be eliminated upon accession for US priority products such as fertiliser and optic fibre cable (within five years for the remainder).

Soruce: Office of the United States Trade Representative.

What WTO entry means for the PRC reform process

In light of the weakening 1998 domestic economy, China appeared to drag its effort for joining the WTO. China's interest for WTO entry has currently renewed and this could be driven by

1. Chinese government's desire to foster the Sino-US ties (as well as other overseas countries), and
2. Chinese government's desire to boost foreign direct investment inflows.

What really catches foreign investors' eyes is the perceived committed from Chinese government to pursuing far-reaching structural reforms of the economy. Indeed, the government appears to view WTO entry as a means by which these reforms can be pushed through.

During recent (April 1998) negotiations, China unexpectedly offered major concessions to the US concurrent with Premier Zhu's US visit, pledging to reduce tariff barriers and gradually open previously protected areas of the economy, such as insurance and banking, to foreign participation.

The market-opening steps that the Chinese government offered will involve some pain. Many of China's state-owned enterprises (SOEs) do not have the efficiency that would allow them to compete with foreign multi-nationals. The entry of foreign companies could therefore aggravate the existing financial problems for China's SOE sector. In 1998, SOE losses amounted to Rmb 155.6 billion (US$ 18.8 billion) i.e. a 22.1% increase y-o-y.

The WTO entry could be devastating for the state-owned domestic banking sector. Due to massive government-directed lending to SOEs in the red, the Chinese banking system is technically insolvent. Chinese banks are burdened with mounting bad and doubtful debt (some banking analysts claim Chines non-performing loans already amounted to a quarter of total loans). The domestic banking system is being sustained and has only been kept viable by China's high savings rate. This high saving rate could be due to the lack of alternative savings vehicles offered by local financial institutions. WTO entry could therefore pose a lethal threat to the domestic banking system. Innovative and customer-oriented competitive foreign banks could quickly reap a handful of the domestic savings currently deposited in state banks.

The fact that the government is willing to put up with changes that would have such negative consequences suggests that the China government remains committed to the economic reforms. These reforms were aimed at restructuring the SOEs and tackling the domestic banking sector problems. As the economy slowed last year, the government's commitment to push through these reforms seemed to weaken. For example, the government (in 1998) called on banks to increase lending to government-inspired infrastructure projects, interfering with efforts to improve asset quality of domestic banks. These WTO concessions indicated that these reforms have not been deserted. On the contrary, , it seems that the Chinese government is using WTO entry as a platform for this structural reforms.

The recent WTO negotiations, up to now (April 1999), clearly illustrate that the Chinese government remains totally committed to commission structural economic reforms of the country. Although these reforms are likely to be painful in the short- term, increasing unemployment and depressing GDP, they are essential if for the long-term well-being of the Chinese economy.

To invest in China or not?!

The author believe investment in China is a choice between (a) financial risk of investing in China, and (b) strategic risk of not investing, or delayed investment, in China.

Obviously, the heydays of China Fever are behind us. What really counts is how to structure a well-positioned and balanced China expansion plan to capture the growth potentials in an effective manner.

To many foreign investors, this is also a matter of balancing their portfolio risks of investing in low-risk saturated market (say US and Europe) and higher-risk growth market in China. It is, essentially, a matter of risk propensity for investors.

Business in the 21st century global marketplace is nothing about risk-aversion, but risk management!

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Appendix I: Pioneering Chinese Issuers of International Equity

Country of Issue	Offer Date	Amount Raised (US$ million)
United States		
Brilliance China Automotive	10/9/1992	80.00
EkChor China Motorcycle Co	6/28/1993	85.00
China Tire	7/15/1993	103.70
Shanghai Petrochemical	7/23/1993	171.00
Huaneng Power International (ADR)	10/1994	625.00
Hong Kong		
Denway Investment (back-door listing)	2/22/1993	51.62
Tsingtao Brewery	7/12/1993	21.70
Shanghai Petrochemical	7/26/1993	43.75
Beiren Printing	8/2/1993	24.21
Guangzhou Shipyard	8/2/1993	41.10
Maanshan Iron and Steel	11/1/1993	41.80
Kunming Machine	11/23/1993	16.50

Source: Bloomberg and PricewaterhouseCoopers Analysis

Chapter 4

Venture Capital Basics

Venture capital is a specialised investment banking product originally pioneered in the States. Organised venture capital investment can be dated back to 1946 with formation of the American Research and Development Corporate by Professor Georges Doriot of Harvard Business School. In the world's more developed economies, venture capital financing is an important source of funds for start-up firms, private middle-market firms, and even public firms seeking buy-out financing.

The venture capital industry's development exemplified how corporate innovation, entrepreneur's vision can be merged with professional skills of financial management elite to bring tremendous success. "Digital Computer" is among the often-quoted success story of partnership between entrepreneurs and venture capitalists.

This chapter seeks to explore how venture capitalists are getting their job done in nurturing growth companies and how their Asian clone evolves and develops amid the Asian business environment.

We're here for today,

we're here for tomorrow and the days to come![16]

[16] Mrs. Ilene R. Moses, Managing Director of Cherry Pickers Ltd. which runs a USD500 million PRC direct investment funds targeted to the textile industry and infrastructure.

Industry Growth in the States

Every emerging and growing business may need venture capital. Venture capitalists risk money and provide expansion / seed capital that permits a small company to grow and prosper. When a visionary entrepreneur invented a new idea or wants to operate his own business, he may seek conventional financing, say loan facility, from a financial institution. To his dismay, he will realise very soon that banks only make loans when the risk of capital loss (credit risk) is very low.

Venture capital investments are characterised by high-risk and this risk cannot be mitigated by deals structuring.

There is a fundamental difference between venture capital and a high-interest loan financing. This is the management assistance extended to the enterprise by the venture capitalist who positioned himself as a trusted business partner and advisor.

Before proceeding to dissect the industry drivers for Asian venture capital, it may worth taking a while to recap the emergence and other historical milestones for the industry.

This can be done by tracking down the history of venture capital industry in the US -- the world's most matured venture capital market.

1946 - 1969

- It was not until late 1950s & early 1960s that the venture capital industry became institutionalised. Formation of American Research and Development Corporate in 1946 at Boston of Massachusetts is commonly regarded as the inauguration for the industry.
- Industry growth was fuelled by *Small Business Investment Act 1958* when Small Business Investment Corporation were formed (and supplemented by government funding in the form of Small Business Administration loans) and enjoying numerous tax incentives.
- Venture capital houses qualify with the U. S. Small Business Administration ("SBA") requirements are able to borrow money

from SBA at lower rates as long they invest their funds in small businesses. (Currently, there are more than 400 venture capital houses qualified to seek financing from SBA.)

<u>1970s</u>

- o Emergence of limited partnership to get around the *Investment Company Act of 1940* which prohibits investment managers to received performance-based compensation.
- o Traditional financial institution started tapping the industry by forming their venture capital arms. Numerous independent professional venture capital houses also emerged.
- o The first industry association, the National Venture Capital Association, was formed in 1973.

<u>1980s and 1990s</u>

- o Consistently reported high returns attracted massive institutional investors (say, pension funds) participation.

To a large extent, this actually illustrated how institutional factors can propel business and industry growth.

The three most important US institutional forces working to propel the growth of venture capital industry are (1) regulatory changes, (2) participation of institutional investors and (3) maturity and growth of industry expertise.

The First Wave

The first wave of growth (1946-1969) is triggered by conductive government policies and regulations including the Small Business Investment Act of 1958 and the gradual tax reform which reduced significantly the tax charge on capital gains. All these legislation are encouraging the then teething venture capital industry which concentrated at providing start-up capital for small emerging businesses.

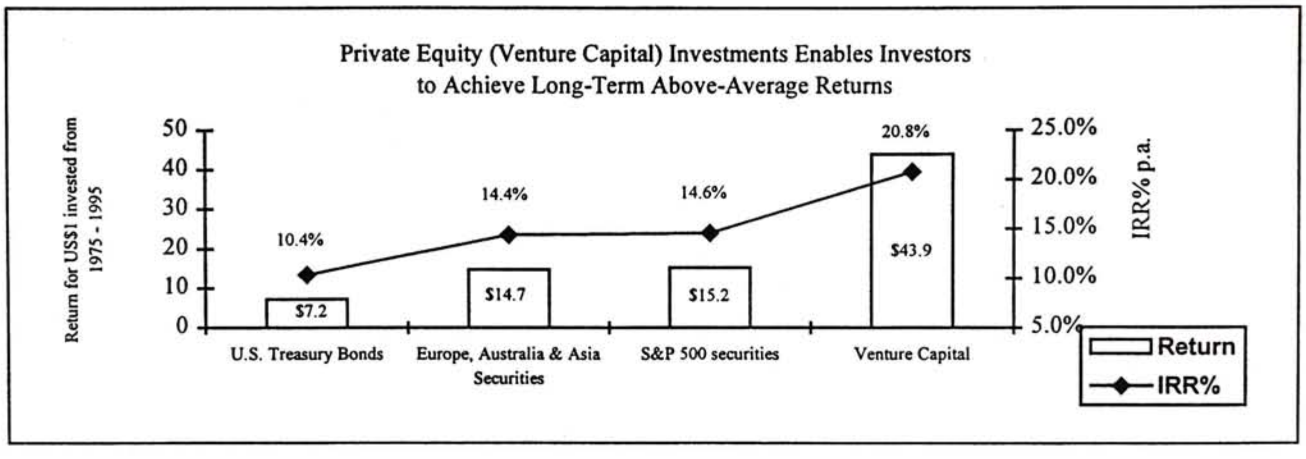
The Subsequent Waves

The subsequent waves of growth (1970s and onwards) are evidenced by extensive employment of professional investment managers by institutional investors to managed their investment funds. A typical US pension fund allocated approximately 2 - 5 % of their money in high-risk high-return ventures. The aggregate investments make by pension funds to the US venture capital pool already rendered them the single largest source of fund for the US venture capital pool.

In line with the institutional participation that increased the venture capital pool, this also nurtured the development of seasoned venture capitalists.

Private Equity Investment Returns and Increasing Popularity

Morgan Stanley Research conducted a research in 1996 and the research findings indicated that venture capital investments (or more commonly being referred to be "*private equity*" or "*direct investment*". Hereafter, "venture capital", "private equity" and "*direct investment*" will be used interchangeably) consistently gives above-average return to investors.



The increasing recognition of the professionalism exhibited by venture capitalists and their marvellous achievements draw further investments from other investors (say endowment trusts and other private investors).

The following table illustrates the splendid investment returns achieved by professional venture capitalists. This proven track record further growth propellant for the industry.

Private Equity Return as of 1996

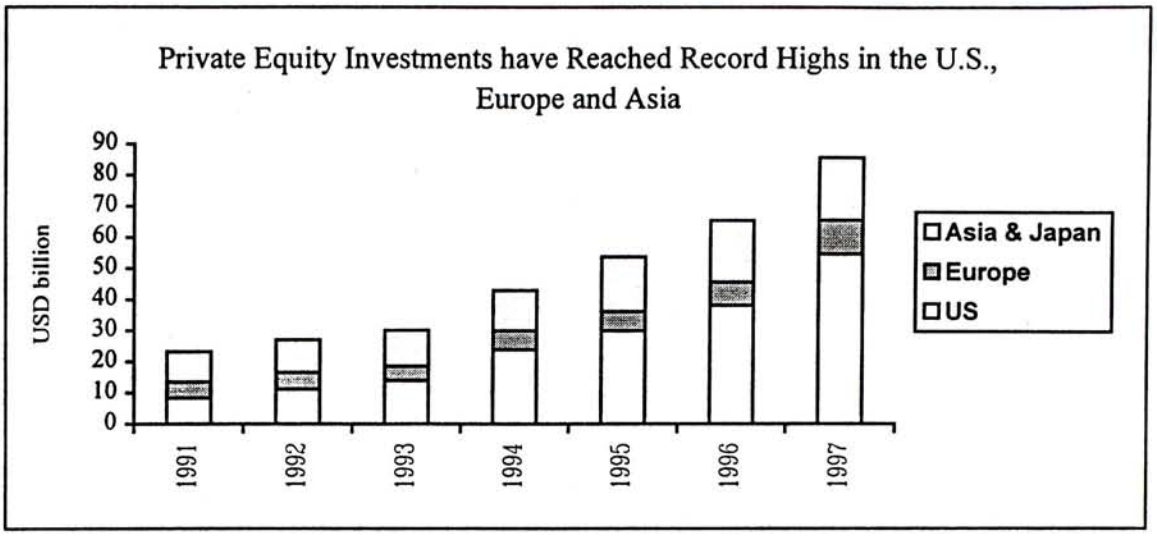
Annualised IRR% by Year of inception	1984	1985	1986	1987	1988	1989	1990	1991	1992#
Maximum %	243.9	54.7	64.5	61.3	70.3	33.8	57.6	30.0	68.0
Upper Quartile %	77.6	35.9	16.7	16.8	16.6	19.9	20.9	25.2	25.9
Medium %	29.9	15.4	9.7	11.5	12.5	10.1	15.1	19.9	16.8
Lower Quartile %	12.4	9.4	7.1	5.9	7.7	-0.1	5.6	10.5	9.7
Minimum %	2.1	1.8	3.0	-33.7	-10.6	-43.9	-6.5	6.0	-24.7

Source: Venture Economics 1997

\# Statistics represent annualised returns. Most funds formed in 1992 will have completed their investment period. Funds formed after 1992 will still be in the process of investing their portfolio, and as a result, analysis of their unrealised investment portfolio may not be meaningful.

The set of similar institutional factors also orchestrated to fuel the venture capital industry's growth in Asia Pacific.

Let us take a closer look at the make-up of the more matured US and European markets before we re-cap the milestones for Asian venture capital industry. Let us start with the relative market sizing for venture capital industry in the three markets:



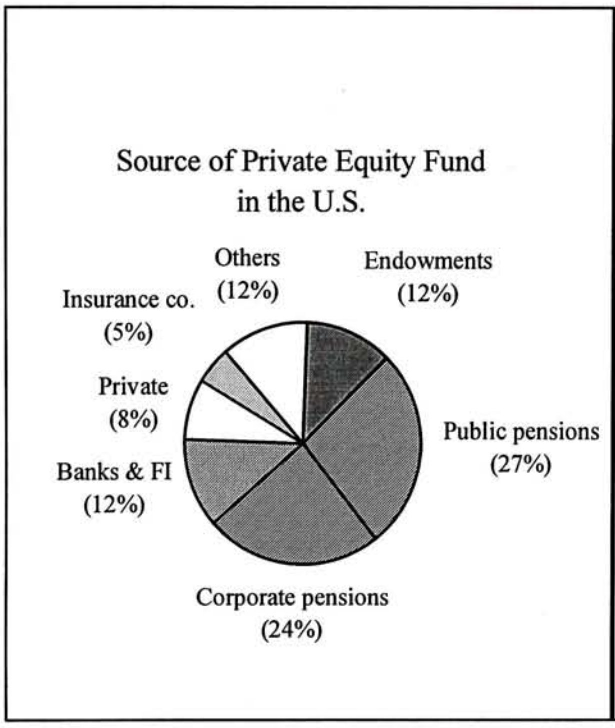
Obviously, the US markets takes up the largest chunk of the pie and attracts investments from all over the world. Thus, US has been ranked the largest recipient of foreign direct investment during the last decade. Despite Asia (including Japan) market is catching up rapidly, it is still, by far, a distant second behind the US market.

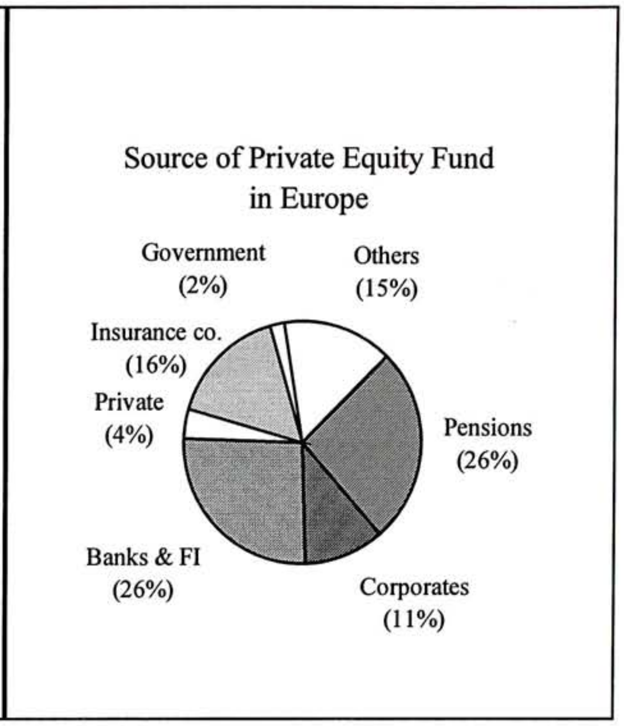
The source of venture capital funds

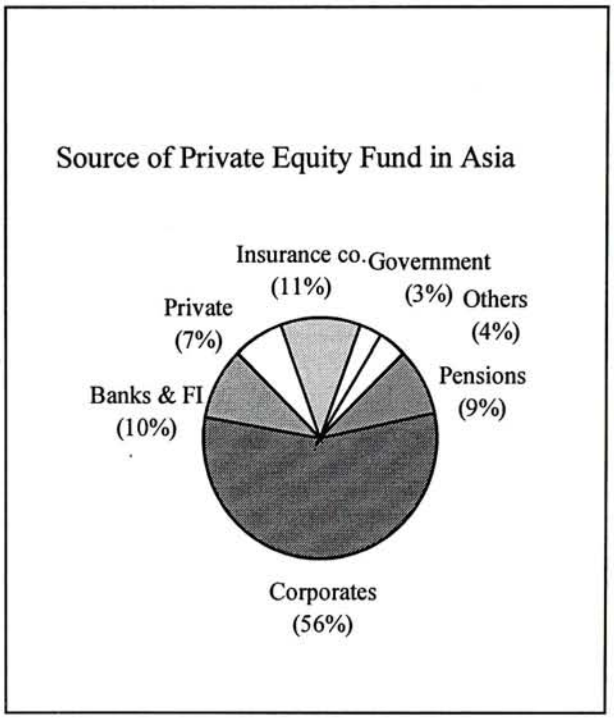
Corporations, insurance companies and banks have provided the majority of venture capital funds in Asia. However, the funding sources differ quite significantly across countries within this region. The venture capital funds in Hong Kong for example, are more developed and have tapped international insurance companies for funding. In Taiwan and Singapore however, local corporations have been the largest investors in venture capital funds. Meanwhile, banks have been the leaders in investing in direct investment funds in Asia.

Up to 1998, the vast majority of funds for venture capital investing in Asia came from regional and domestic sources. The latest industry statistics in 1996 revealed 74.1% of funds came from Asian sources. The following groups were the most active in funding Asian venture capital up to 1998.

1. *Insurance Companies.* American insurance companies have been the leading investors in Asian venture capital funds in recent years, especially in funds based out of Hong Kong. The most active insurance companies include AIG/AIA and Prudential (which also manage their own funds) and John Hancock, Allstate and The Equitable (which tend to be limited partners in various funds in the region).
2. *US Commercial Banks.* The American commercial banks have also greatly increased funding for direct investments in the region. Citicorp, Chemical (later reorganised into the Chase Capital Partners) and Bank of America have established their own funds and management in the region. The *US* investment banks also followed their commercial banking counterparts.
3. *Corporate & Public Pension Funds.* Several private and public sector pension funds have increased their participation in Asian direct investments. (This includes Schinedler Group, GE Capital & The California Public Employees' Retirement System.)
4. *University endowment funds.* Fuelled by the rising intention of *US* schools to go international, their making of direct investment in Asia is not unpredictable. The more active endowment funds include that from Massachusetts Institute of Technology and Harvard University.







Source: National Venture Capital Association,
European Venture Capital Association,
Asian Venture Capital Journal 1997

We could see from the chart that source of funding differs significantly for the venture capital industry in the three markets. In the US, well-developed pension funds is the most important provider of venture capital financing while in the Asian market, it is the individual corporations that provides the largest mass of the cake.

The Asian Migration

The venture capital “”“”industry in Asia has grown rapidly in the past few decades. According to the *Asian Venture Capital Journal,* the Asian venture capital pool grew from US$21.9 billion in 1991[17] to approximately US$36.1 billion in 1997. The industry growth, as measured by number of professional venture capital management firms, was also breathtaking. The industry demonstrated a rapid growth from 334 firms in 1991 to 827 firms in 1997.

Table 1: Asian Venture Capital Pool 1991-97 (Funds Under Management)

(US$ million)	1991	1992	1993	1994	1995	1996	1997
Hong Kong / China	2,173	2,656	3,095	6,037	8,044	8,729	10,670
Indonesia	76	57	99	225	245	289	426
Japan	15,352	16,028	17,750	17,750*	14,851	11,254	7,722
Korea	1,547	1,629	1,687	1,902	2,567	3,224	1,857
Malaysia	75	147	160	194	437	448	406
Singapore	868	896	1,013	1,833	3,164	3,981	4,468
Taiwan	412	470	508	562	696	1,336	1,913
Thailand	64	90	98	117	165	201	177
Other countries not listed							
Total	21,925	23,431	26,222	30,951	33,433	33,791	32.136
# VC funds	334	354	399	659	752	839	827

Source: Asian Venture Capital Journal, 1998
** 1993 figures (1994 figures not available)*

Despite such rapid growth, little has been written about the development of venture capital funds in the region, their investments and transactions, or strives to portrait how the industry will develop in the future.

[17] All statistical data quoted in this chapter, unless otherwise stated, is extracted from Asian Venture Capital Journal 1998

Many industry observers, however, have commented that investment funds have increased too rapidly, and that attractive rates of return will not be sustainable.

This section of the report will briefly highlight,

1. the development history of direct investments in the region;
2. how Asia venture capitalists learned from their US and European counterparts;
3. the historical milestones for the direct investment firms tapping into China; and
4. how venture capital could gain higher investor / investee profile in China.

In addition, this paper will only analyse the activities of the *organised* venture capital funds in Asia. Organised venture capital firms are defined as corporations or partnerships whose main activity consists of raising funds and investing in private equity situations. Venture capital activities by individuals (despite being an organised personal wealth investment risk diversification) are beyond the scope of this report (i.e. include corporate venturing but exclude other forms of long-term and strategic direct investments).

The Emergence of Asian Pioneers

The venture capital industry in Greater China, Southeast Asia saw its formal inception in 1981, when Arral & Partners (Asia) Ltd. was formed by two former bankers (Louis Bowen and Anil Thadani) in Hong Kong. Arral started with a US$ 75 million fund targeted at investments throughout the region. Despite the partnership was terminated in 1992, it cast a remarkable milestone in the development of Asia Pacific private equity industry.

The industry however, remained quite inactive until 1985, when institutional investors began to raise funds and establish offices in the region. Three companies that played important roles in the development of the industry at the time were ChinaVest, and Hambrecht & Quist, and Prudential.

(1) ChinaVest

ChinaVest was established in 1985 in Hong Kong by Robert Thaleen, a military veteran who remained in the region after the Vietnam War. ChinaVest was among the first to raise US institutional funds and invest in companies in China. Thaleen invested mostly in Hong Kong businesses expanding in Guangdong province. The returns from these early investments were reported to be in the range of *30-40% p.a.*

(2) Hambrecht & Quist

In 1986, Hambrecht & Quist (H&Q), one of the leading investment banks for the technology sector in the United States, established operations in Taiwan and Singapore. Ta-Lin Hsu, a principal at H&Q, first invested in technology companies started by Taiwanese returnees from Silicon Valley. H&Q eventually established several small funds, each between US$5 and US$20 million, to invest in the "dragon" economies of Taiwan, Hong Kong and Singapore. Most of H&Q's initial investments remained in the electronics and technology sectors, but the firm later expanded its range of investments to include consumer-related and industrial companies.

(3) Prudential Asset Management

In the same year, Prudential Insurance Company committed US$ 500 million for direct investment in the region and formed Prudential Asset Management Asia (PAMA) to oversee the company's Asian private equity investment activities. This was a major event in the Asian venture capital industry because up to that time, only limited funds had been committed to the region. Prudential's use of its own funds, rather than the funds of other institutions, allowed the immediate injection of a large pool of capital into direct investments in the region. PAMA is headed by a Hong Kong local business leader, Mr. Victor Fung, who pioneered full-scale direct investment business with initial focus on non-technology companies in Southeast Asia. This also marked the prelude of high-profile involvement of Hong Kong business community' in organised venture capital investments.

These three firms probably had the greatest impact on the venture capital industry in Asia for several reasons.

1. the arrival of these firms helped increase awareness among local and overseas institutional investors about direct investment in the region;
2. these fund managers were able to demonstrate that proven Western professional venture capital methods could operate successfully in Asia's less developed financial, legal and accounting business environments;
3. these firms also increased the number of investment professionals in the region. Alumni from these initial funds would later bring their expertise to new institutions, or would later establish their own funds; and
4. by having these pioneer venture capitalists instituting a workable framework for Asian venture capital industry, the industry was able to attract and retain professional managers with a diversity of experience and background to propel the further development of the industry.

The Asian venture capital pool grew at a compound annual growth rate of over 20% during its teething stage (from 1988 to 1991). The pool's growth during the initial years can be attributed to the following reason:

1. the high returns from the early entrants such as Arral, ChinaVest, H&Q, and Prudential stimulated the formation of more funds. The respective company brochures reported these early funds achieved returns in excess of 20% per year;
2. the recession of the late eighties and early nineties in North America and Europe weakened the returns for venture capital in these regions: many international direct investment firms began to target Asia (as part of their globalisation and diversification program);
3. investors started to identify and spot opportunities from "market opening" and deregulation of many Asian economies, particularly those in China and Southeast Asia.

The Asian venture capital pool has witnessed its greatest growth in the past decade, as we saw new funds increased by an sustainable annual compound growth rate of 6.8% during 1991 to 1997. This proliferation phase of the private equity pool can be attributed to the following reason which actualised (or emerged) during this period:

1. *Large valuation differentials between private and public securities.* During early 1990s, the stock exchanges in Greater China, and the Southeast Asian countries skyrocketed to new pinnacles. As

illustrations, the market capitalisation of the stock exchanges of Hong Kong, Thailand, and Malaysia all increased by over 100% during this period. Price-earnings ratios of Southeast Asian equities also exhibited a significant increase. Meanwhile, private equity entry multiples remained in the single digit range (typically 3x to 5x). Venture capitalists realised that large profits could be achieved by investing in expansion stage companies and taking them public on the Asian domestic stock exchanges.

2. *Escalating familiarity with Asian equity markets.*

   The (Asian domestic and US) insurance and pension funds started invested heavily in Asian equity markets in early 1990s to capture the market capitalisation growth. After gaining familiarity with the Asian public equity markets, the pension funds (and other institutional funds in US and Europe) started to seek higher returns from unlisted investments in the region.

3. *Asian Infrastructure investments on the spotlight.*

   Asian infrastructure (including public utilities companies) became an extremely popular theme with US institutional investors recently (during mid-1990s). The infrastructure-related investment offerings in the Asian public equity markets in Asia however, were quite limited at that time. Several large financial institutions, including AIG/AIA, the Soros Foundation, and GE Capital have siphoned billions of dollars in recent years to new private equity funds for infrastructure in Asia. These professional investors want to participate in the growth offered by progressive de-regularisation (in particular permitting foreign direct investments) of Asian infrastructure and public utilities industries. They eye the high growth potential offered in the Asian emerging market, as compared to the relative stagnant growth in their home country's saturated market.

The author will wrap-up this section by a snapshot of actual project disbursement of the Asian venture capital pool.

1997 Asian venture capital pool actual disbursements to industry

Industry	Amount Invested (US$ mil)	Percent of Total (%)	Number of Companies
Consumer related	3,373	16.9	3,233
Computer related	1,677	8.4	1,764
Electronics related	1,836	9.2	1,940
Industrial products	3,094	15.5	2,775
Medical / Biotechnology	659	3.3	557
Communications	1,537	7.7	751
Energy	759	3.8	543
Transportation	858	4.3	364
Construction	1,777	8.9	1,287
Financial Services	858	4.3	832
Other Services	1,477	7.4	1,741
Other Manufacturing	2,056	10.3	2,033
Total	19,961	100.0	17,820

The China Fund Crusaders

Development of China Direct Investment Funds

Period	:	Driving Forces (Approximately Size of Pool)
1986 - 91	:	Small private investment groups & small PRC Ministry-backed funds (US$240 million)
1992	:	Corporate investors mainly represented by regional (Asian) investment groups & industrial groups (US$925 million)
1993	:	Large American investors & extensive PRC Ministries' support (US$3 billion)

In line with the China Fever in 1993 and 1994, China direct investment funds also demonstrated vigorous adaptations and robust expansion in the early 1990s. Industry consensus categorised the early developments of China direct investment funds into three waves. Each wave is characterised by emergence of a specific pattern in either deal sourcing, form and structure of investment projects, or affiliations of investment funds.

The author believes professionalism and institutionalisation of the investment process is the key to the 1990s splendid germination of Asian direct investment funds. By having a more organised and co-ordinated effort, this group of China direct investment funds is able to pave the road for other investors investing into China. The latecomers could now conduct their business in a more transparent and healthy set of institutional factors.

First Wave (1986 - 1991)

The "First Wave" of China direct investment funds was characterised by small private investment groups (most of which were based in Hong Kong) & some small-size PRC Ministry-backed investment funds.

The formal inception for the era of China direct investment funds rooted in 1986 when Hong Kong-based independent investment house ChinaVest successfully raised the first US$12 million China direct investment fund. Established in 1980 by Robert Theleen, this company has grown from an investment consultancy firm into one of Hong Kong's largest independent private equity fund management group. (ChinaVest's show-case investments include the Domino's Pizza and TGI Friday franchises. It's brilliant track-record is, however, dimmed by its 1995 controlling-stake investment in KPS Retail Stores, a down-trodden home entertainment products retail chain which was caught under spotlight and attracted extensive media attention.)

Hong Kong solicitor Victor Chu who co-headed ChinaVest during 1987 and 1991 mimicked this groundbreaking launching. Victor raised his own US$20 million Kwong Wah Investment Fund. His firm, First Eastern Group, up to now is still the largest Hong Kong-based independent private equity investment house.

In less than 1 year, we also saw China Venturetech Investment Corporation (with the then State Science and Technology Commission as its major shareholder) raised its own US$37 million direct investment fund. This is another groundbreaking milestone as this company is the first Chinese home-grown professional private equity investment house. Although China Venturetech closed down its business in 1998, it nourished the first batch of locally brought-up talents for the industry.

During these early days, this group of investment professionals is characterised by a relative small fund size. The author believes this is due to absence of an availing investment climate and lack of institutional investor's participation. The then professional venture capitalists are characterised by their mainland Chinese business affiliations.

Second Wave (mid-1992)

The Second Wave is characterised by the front-end involvement of corporate investors which include by regional (Asian) investment groups & other Asian conglomerates seeking overseas expansion opportunities into China.

Leverage on their proven Asian experience, this group of newcomers brought with them

1. enhanced financial resources to flourish a larger venture capital pool to support future investment projects,

2. economies of scale and synergy with their respective portfolio companies in sourcing China investment opportunities,
3. professional management expertise and manufacturing know-how, and
4. established relationship with overseas institutional investors which broadened the investor base,

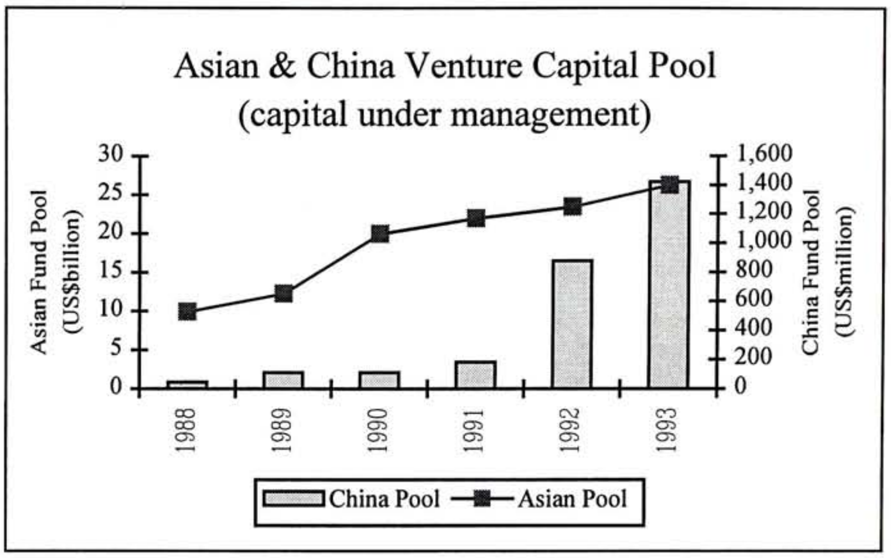
All these built up the backbone for proliferation of mega (> US$100 million) China direct investment funds in the forthcoming Third Wave era.

The author believes this wave of investment boom is due to a more transparent government policy by the Chinese government. Booming of this wave was ignited by the 1992 visit of Chinese leader Deng Xiaoping to Southern China which demonstrated the central government's support to uphold its "Open Door" Policy". This cleared institutional investors' doubts and foreign investors' concern on China's determination to sustain its economic reform.

Third Wave (1993)

International investors always value predictable and consistent government policies. The 1992 Southern China visit by Deng Xiaoping served to demonstrate Chinese policy-makers' commitment to economic reform and encourage foreign direct investment.

During this stage, we could see exponential growth in funds earmarked for China direct investments. The following chart illustrates the fund size for Asian and China venture capital pools which clearly indicated the exponential growth of China direct investment funds since 1992.



(Source: Asian Venture Capital Journal)

The early successful story of China direct investment funds and institutionalisation of the industry attracted participation from deep-pocketed American institutional investors. They participate either by launching their own (or co-invest) in China direct investment funds or through allocating a PRC portion from their regional / global investment fund pool.

Hand-in-hand with American institutional investors' participation, we also identified additional involvement from State Council Ministries and other Chinese government agencies. We saw more and more cross-border alliances and joint ventures formed during this period. Depending upon the background and strength of the Chinese affiliates.

Industry or geographic-specific funds also emerged due to broadened co-investor base which now includes high-profile State Council Ministries and government agencies. Typical examples that comes to my mind include the industry-specific Tien Lee China Aeronautical Technology Fund's fund and geographic-specific funds such as SHK Pearl River Delta Investment Fund and AIG / Guangzhou Investment Fund.

Fund management firms

Apart from Asian operations of the established US / European venture capital houses, the Asian venture capital fund managers can be categorised into the following 5 groups:

1. *Local independent venture capital firms.*
   The independent direct investment firms include partnerships such as Arral Partners and ChinaVest mentioned above.
2. *Affiliates of international insurance companies.*
   This category of venture capital funds is backed by the insurance companies and includes Prudential Asset Management Asia (PAMA) and American International Group/ American International Assurance (AIG/AIA). These funds tend to be large (typically over US$ *250* million) with much of the funding coming from the parent insurance company.
3. *Investment Banks from Hong Kong/UK & America.*
   This group of direct investment firms comprises almost all of the merchant banks in Hong Kong, including local and British merchant banks. Starting in the late 1980s, these institutions entered into the direct investment battlefield.
   Some of the more active merchant banks in this industry include Schroders, Hong Kong Bank, Standard Chartered Bank, Peregrine (no longer in the Asian venture capital scene), Kleinwort Benson (now Dredsner Kleinwort Benson), CEF (the merchant bank of Tycoon Li Ka Shing's Cheung Kong group), and Jardine Fleming. Most of these firms are based in Hong Kong and are focused primarily on greater China. (This group also includes Goldman Sachs, Morgan Stanley, Donaldson

Lufkin Jenrette, JP Morgan and Bankers Trust. Most of the investment banks invest in Asia by allocating an Asian portion from their global direct investment funds.)

4. *Commercial Banks.*

   The commercial banks are expected to become increasingly active in direct investments in the region by tapping their Asian business into the direct investment sector. The are leveraging on their established business network and client contacts. The Bank of East Asia is among this group of newcomers.

5. *Corporate Venturing Clone* (including corporate insurance fund managers) *and their outgrowths.*

   Most of their companies are taking a very low market profile. The more prominent and high-profile ones include GE Capital and Lee & Fung Direct Investment.

What Entrepreneurs don't Know about Venture Capital

From my job-related contact with entrepreneurs, the author prepared the following list of questions that are commonly raised by entrepreneurs who come to venture capitalists for the first time.

1. How could entrepreneurs maintain proprietary manufacturing techniques or business processes confidential in light of new equity investors?
2. How will private investors participate in a deal?
3. What is the common disclosure and on-going obligations required from entrepreneurs?
4. What is the comfortable investment amount for private investors.
5. What are the project selection criteria used in evaluating a deal?
6. What is the return and time frame required from the private investors.
7. What is the typical structure of private deals
8. Where can the entrepreneurs meet and be introduced to the right private investors?
9. What are the typical investors in private deals.
10. What will the private investors bring to the company besides their investment money?

The section that follows will answer questions 1 to 7 listed above. (The chapter that follows will provide an answer to questions 8, 9 and 10.) One thing that is for sure is that venture capitalist not only provides expansion capital to emerging business. They will distinguish themselves from commercial bankers by providing value-added financial and strategic advice to their investee companies.

Common Deals Structure and Patterns of Investments

Common Private Equity Deals Structure

Equity Interest	:	Minority equity interest of 20 - 30%.
Entry Price	:	Normally at only 3 - 4 times of current year profit.
Dividend	:	Annual cash dividend or other covenants on dividend distribution.
Put Option	:	Option to sell-back shares to the majority owners under certain conditions, say a. profits significantly below forecast b. fail to go public c. end of a definite period (normally 3 - 5 years)
Operational Surveillance	:	Team up with established operating partner within the industry. Owner-manager will take care of the daily operations and all the shareholders shall sign a confidentially agreement among themselves.
Business Scope	:	Viable products (either revolutionary, innovative, evolutionary or substitutions) with secured distribution and procurement network.
Board Representation	:	Right to appoint director to represent investor in the Board of investee company.
Management Reporting	:	Management accounts on monthly (or at least quarterly) basis.
Annual Audit & Examination	:	Audited statutory accounts (normally by Big 5 international accounting firms) with right to employ independent auditors to review and examine investee books & records.

Looking into the Future

The author saw a very unhealthy trend in Asian (especially China) venture capital industry. The industry players tends to adopt a generic approach i.e. focus on pre-IPO investment without much involvement in business operations management. Asian venture capital funds managers are mostly purely financial investors and have yet to exercise their value-adding roles in their portfolio investee companies. This reliance in generic type investments may limits our industrial developments as this brings:

- limitations on deal sourcing & creates reliance on intermediaries. Industry players have to ensure goal-alignment with our intermediaries and may need to develop alternatives such as industry specialisation etc.
- limitations on negotiation power with reference to valuation and pricing terms. The inherently low price flexibility of pre-IPO offer (with IPO price as benchmark) renders elaborate valuation models and complicated pricing structure excessive. Structuring of exit protection such as put options will become increasing difficult in this competitive market

While the amount of private equity funds committed to the region may increase at an uncertain pace, several factors indicate that venture capital returns in Asia will remain superior to those in the US The reasons for a potentially-higher return are:

1. Buying into low (of a historically-high economic growth region).
   Economic growth rates are historically considerably higher in the Asia region (in the per-Asian Financial Crisis years), and re-bound is predicted to crystallise within the next 3 - 7 years. Buying into lows and wait for the next economic upswing may offer significantly higher return than investing in other matured markets.
2. Broad based investments.
   Venture capital funds in Asia are invested quite evenly across a number of industries including consumer products, technology, manufacturing and infrastructure. This diverse portfolio should be subject to less risk than the venture capital pool in the US, which focuses more on the technology and biotechnology sectors.
3. Low venture capital penetration.
   Penetration rates for venture capital in Asia are still low compared to the United States. Penetration rates are derived by dividing total venture capital funds by Gross National Product for each country. Based on this analysis, Asia has only US$3.54 of venture capital funds for every

US$1,000 of GNP, while the rate for the US is US$5.79. The analysis indicates that the Asian venture capital industry is not saturated yet.

4. Inadequate sector representation in Asian public equity markets.
   The public equity markets in Asia, particularly Hong Kong, Singapore and Thailand, are dominated by property and financial sector companies. The composition of these equity markets does not reflect the components of their respective economies. Thus, investors can better access under-represented sectors through private equity investments.

All these aforementioned factors apply particularly well in China especially for its under-developed securities market. Obviously, we have to admit that, to a certain extent, international investors' interests in China have gone lukewarm. Up to the end of mid-1990s, China was the primary target market for most direct investment firms in the region. About sixty percent of all the funds in the region in mid-1990s were managed by firms based in Hong Kong: this not only reflected the tax and legal advantages of Hong Kong, but also the interest of most of the funds to be located on the doorstep of China.

In recent years (starting from 1997) however, overseas investor interest in China has waned due to

1. persistent inflation, which may cause instability in the non-coastal regions due to the intensifying income parity;
2. lack of well-founded legal and enforcement systems;
3. inadequate financial information and standards for protection of investors;
4. bureaucracy at local, provincial and municipal levels of government. This is further complicated by the role of government regulatory ministries having their own conflicting business interests;
5. lack of consistent and predictable government industrial policy; and

6. negative media coverage of disputes between foreign companies and Chinese enterprises.

Despite these problems with China, many investment professionals still feel that it offers the most promising private equity opportunities in Asia if certain successful strategies are replicated and followed. (Please see Chapter 7 for "Critical Success Factors for Venturing Capital Houses operating in China")

Overview of Venture Capital in China

Sources of Venture Capital Funding

Out of the total capital of US$3,612 million, corporations accounted for 56% . Insurance companies and pension funds followed with contributions representing 11.2% and 9.2% of the total respectively. A breakdown of this total amount by source and by countries is set out as follows:

By Source:	Percentage
Corporations	56.0%
Insurance Companies	11.2%
Banks	9.7%
Pension Funds	9.2%
Private Individuals	7.0%
Government Agencies	2.9%
Others	4.0%
Total	100.0%

By Countries:	Percentage
China	36.7%
Hong Kong	12.8%
Non-Asian Countries	38.7%
Other Asian Countries	11.8%
Total	100.0%

(Source: Asian Venture Capital Journal)

Disbursement of Funds

Out of the total capital of US$3,612 million, an estimated US$2,812 million have been invested in the following industries as of end of 1997:

Industry	Amount Invested (US$ mil)	Percent of Total	Number of Companies
Consumer related	355	12.6	52
Computer related	52	1.8	8
Electronics related	123	4.4	26
Industrial products	375	13.3	59
Medical / Biotechnology	31	1.1	7
Communications	34	1.2	7
Energy	277	9.9	37
Transportation	322	11.5	34
Construction	689	24.5	41
Financial Services	21	0.7	5
Other Services	75	2.7	21
Other Manufacturing	458	16.3	30
Total	2,812	100.0	329

(Source: Asian Venture Capital Journal)

Problems facing VC firms

Despite the Asian opportunities which opens the door for venture capitalists, the fact remains that direct investment in the region is full of challenges, especially for those firms that are used to operating in the United States and trying to replicate their US success stories in China. Some of the difficulties faced by venture capital firms in the region include:

1. *Lack of legal structures.*

   Many of the countries in the region lack the legal systems for limited partnerships and full-fledge minority shareholders protection. This obviously makes local fund formation more difficult.

2. *Lack of secondary equity markets.*

   Some countries in the region, most notably Hong Kong, lack secondary markets for smaller company listings. The minimum capitalisation for a listing on the Stock Exchange of Hong Kong (SEHK) is HK$ 50 million, but most investment banks will not underwrite issues less than HK$ 100 million. In addition, all firms listed in the SEHK must have at least three consecutive years of profitability prior to listing. Venture capitalists and The Hong Kong Association of Banks has recommended that a second board should be established to increase the chances for exit via initial public offerings. (As of April 1999, the SEHK already proposed a Growth Enterprise Market to answer the call from the investor community. Consultation Paper has been issued to collect comments and opinions from the general public as well as the investment profession.)

3. *Deal flow.*

   China has yet to establish its own network of deal flow and open forum system which create direct contact between potential direct investment investor and investees. The author has yet to see any formal organisation of an industry association in China targeting at building a national-wide investor / investee forum which is necessary to further propel the growth of venture capital industry in China.

4. *Lack of investment professionals.*

   Most of the funds are based in either Hong Kong or Singapore, where management talent is increasingly scarce. Professionals with corporate finance backgrounds are in especially high demand as international merchant and investment banks move into the region. It is both difficult to train and retain seasoned venture capital investment professionals.

Conclusion

From rather modest beginnings in 1981, the Asian venture capital industry has evolved into one with a large capital pool, international investors base, and an enviable investment record. The industry today is composed of local venture capital firms, local and international investment banks, commercial banks, global insurance companies, and major US venture capital firms. These funds are being invested in a broad array of expansion stage companies in the consumer, manufacturing, and infrastructure sectors.

Many investors however, question whether the rates of return for venture capital firms in Asia can be sustained. Industry observers have compared the recent flood of funds into the region with the fatal expansion of venture capital funds in the US from 1981 to 1983. However, high economic growth rates in the emerging market, a diversified range of investments, and other factors indicate that the rate of return for direct investment firms in the region are sustainable and should continue to exceed those found in other parts of the world.

Institutional investors however, should exercise caution when allocating funds to venture capital in Greater China, Southeast Asia or the Subcontinent. Funds should only be directed towards venture capital firms that have a track record in the region, sufficient investment professionals and infrastructure, and an attractive mix of targeted industries and countries for investment.

VC

Chapter 5

The Capital Gap

Owner-operators who own and operate their own businesses as well as other small-scale emerging businesses have very special needs. At one day, this can be a thirst for manufacturing know-how and technical support, the other day can be expert advice on corporate re-structuring, and, almost common to all business entrepreneurs, the pressing demand to satisfy their cashflow and financing needs. These are typical problems for emerging businesses and many of our world-renowned industry leaders painstakingly survived through this learning curve and grew to become leaders in their fields.

At the start-up business stage of business, few financial resources are available to owner operators and "seed money" is generally provided solely by themselves and / or their family members. This will limit scope of operations and size of expansion of these emerging businesses. We can say although the entrepreneur opportunities seem to be clear as outlined in the business plan, these opportunities will only be realised if management has the knowledge and experience to capitalise on them. In most circumstances, "venture capitalists" is the only external resource of financing that is available at the start up stage.

Owner-Manager Entrepreneurs, having a very special needs, tend to look for professional relationship with a financial adviser who understands the wide range of services required by them and ensures they receive the right and timely advice.

The previous chapters analysed the “buy side” considerations of private equity. In this chapter, we will explore the “sell side” considerations highlighted above. Some suggestions are identified to align the “buy” and “sell” sides.

We will look into the financial needs of growth companies and how partnering with venture capitalist can be mutually beneficial.

"There shall be more money chasing after good deals

than good deals wandering around and

waiting for expansion capital!"

It is a matter of learning how to access capital sources,

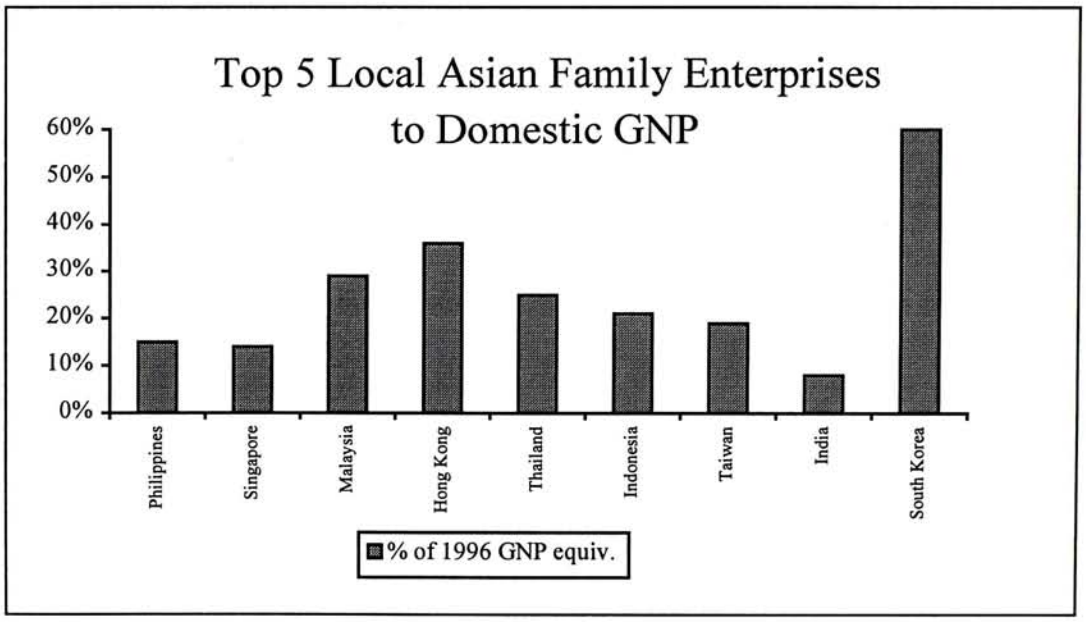
and addressing critical management factors which

investors will look at.

Asian Emerging Businesses Offer Venture Capital Opportunities

Historically, Asian emerging (and usually family-owned) small to medium-sized businesses ("SMEs") are building block of the Asia Pacific prosperity. It is instrumental for us to acquire a brief understanding of their evolution and growth pattern and how they can satisfy their financing needs at different growth stage. We can visualise how these emerging businesses can be nurtured before they become financially and commercially viable.

To put the Asian SME importance into figures and get a taste of their economic importance, we could see from the following graph how their make up the bulk of GNP in their respective countries:



Source: A. T. Kearney White Paper on Revolution of the Asian Entrepreneur

The above chart fully exemplified the commercial importance of Asian SMEs and how they could contribute to the growth of their countries' emerging economy.

China Business Strategy and Outlook for Venture Capitalists - a SME perspective

The author believes China will continue to be a favourable and attractive investment destination because of:

1. major infrastructure development programs which offers sizeable investment opportunities and increase China's internal efficiency and competitiveness,
2. improving business environment due to establishing of more transparent and regularised legal and business frameworks,
3. major privatisation efforts and more liberalised business environment by eliminating political influences over business decisions,
4. high risk / reward ratio arise amid these institutional factors changes in the post-Crisis era, and
5. lifting of legal hurdles (and increasing competitive entry pricing) for foreign investors to acquire Chinese domestic enterprises. Alternatively, business start-up costs have also been driven down by codling effect after the 1997 / 1998 financial turmoil.

The improved business and investment landscape will trigger local investment sentiment and attracts foreign investors (in their post-Crisis strive to "buy low" with a reasonable hope of "selling high" in the years to come). However investors should still be careful as

1. increased competition for shortage of quality & viable deals is still driving up the cost of investment (this is not restricted to China, particularly in the Asian newly industrialised nations such as Taiwan and Singapore in the post-Crisis era)
2. deflationary pressure in the regional, austerity program in China (and other South Eastern countries as well as their political and currency

uncertainty) could lead to slower regional economic growth and sluggish stock market which adversely affect exit timing and valuation

The 1997 / 1998 Asian Financial Crisis injected a more-than-adequate dose of catalyst for Asian counties to (a) re-think their core competency (b) re-invent themselves and (c) re-align and re-allocate their economic resources. All these gives rise to broaden political and economic reform which see Asian countries' way to more consolidated competitiveness in the 21st century marketplace.

Asian countries proved themselves to be responsive to changing customer demand and being reflective in their business dealings. The bulk of the Asian "business agility" is contributed by the region's numerous SMEs which exhibited exponential growth in the pre-Crisis Asian heydays. The post-Crisis general liquidity squeeze has choked the impulse of Asian's SMEs.

Associated with this "Asian suffocation" are numerous entry opportunities for the deep-pocket venture capitalists who already established themselves within this region.

The author recapped below elements that moulds investment sentiments in the pre- and post-Crisis arena.

Business Environment	Pre-Crisis	Post-Crisis
Money supply	o excess liquidity pouring into money market and sparked enormous asset value inflation	o indiscriminate roll-out of recessionary monetary policy may even suffocate enterprises with sound fundamentals
Provision of credit	o ill-regulated bank lending and easy credit	o dry out of bank lending o even fundamentally sound enterprises are difficult in getting essential working capital and trade financing
Regulatory framework	o inadequate regulatory infrastructure / cultural differences not adequately recognised	o aroused awareness in the regulator & institutional level to regularise the playing field
Investment sentiment	o abundant idle money chasing after investment projects and drives investment return unreasonably low	o investment money vanished and projects are evaluated by extravagant (even unhealthy) level of risk-aversion o enterprises may have to seek non-bank alternative source of financing (offer potential for venture capitalists to share financial success in the next economic upswing)

Despite the apparent immunity from the Asian Financial Crisis and the widespread liquidity squeeze that follows, Chinese SMEs (both the foreign-invested and domestic ones) already encounter difficulties in financing their growth.

These Chinese emerging companies, generally smaller in size and more responsive to dynamic business environments, may lost this twinkling opportunities to capture the lucrative niche market and opportunities that emerge from the Asian economic restructuring. My banking sources indicated that more and more American and European businessman are shifting their Asian merchandise procurement basis from other debt-ridden and fragile Asian economies to China for the perceived political stability. The Chinese companies, however, are unable to cater for the new business demands for their lack of expansion capital and , sometimes unfortunately, working capital. The recovery of Asian business viability is largely a function of how fast these responsive SMEs could re-gain their financial strength and re-capture their business impetus. The necessity to seek alternative non-bank financial resources to fuel the region's economic growth deserves immediate attention to business executives all over the region.

Rooting the Finance Gap for SMEs

We now understand how the survival of SMEs is indispensable to the Asian recovery. The section that follows tries to provide an explanation for the increasing difficulties for Chinese emerging companies to secure the necessary financing.

What do Banks Look for in Making a Small Business Loan?

The following is a list of major items a banker might look for when evaluating a loan application[18]:

1. Entrepreneur's level of experience. This represents the education level or practical experience necessary to make the business a successful one.
2. Entrepreneur's personal credit history. This may include getting bank reference from the entrepreneur's banker. The bank may even ask for personal guarantee or pledge of assets for a first-time borrower.
3. Quality and quantity of liquid assets of the business. This is to evaluate the business' ability to meet short-term financing needs.
4. Profitability of the business. This involves submitting past and current statements of operations and balance sheet. On top of this, future profit projections and cash flow analysis may also be requested by the bank.

In particular, commercial banks in this region generally prefer larger-sized businesses. In performing credit analysis, they generally scrutinise on

1. How much the business need.
2. How will the new financing help the business (say reduced cost, increased cashflow, and increased sales)
3. How will the company pay back the loan? The banker may require year-long / quarterly cash projections and compare this against the business / owner-manager's track records.
4. The entrepreneur or majority shareholder's personal stake in the business (the "*hurt money*").

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[18] "What do Banks Look for in Making a Small Business Loan?". The Small Business Journal. (Internet Version at www.tsbj.com) February 1998.

5. How will the company repay if things don't plan out? This is essentially what banks could reasonable recover from the business when it went wrong. Typically, bankers may require contingency plans, and more importantly, collateral and asset-based mortgages.

The author sees no reason why the Chinese emerging business could not satisfy the bakers for requirements (1) and (2). However, their lack of established and verifiable track record, limited (and sometimes already exhausted) owner-manager's financial resources, and absence of collateral could hardly satisfy the bankers for requirements (3), (4) and (5).

The region's commercial banks are generally hesitated to extend credit to developing smaller-scale businesses and prefers dealing with world-renowned big-names. In many cases the financial institution are facing an internal problem of asset allocation which restricts extension of credit to small and medium-sized firms.

The author hates to reach this conclusion but has to conclude that start-up and emerging businesses may fail these stringent credit criteria and have to turn to family financing and / or other alternative financing. (Please see Appendix 1 for a list of suggested "Alternative Non-Bank Financing".) Among these feasible alternative financing methods, equity financing from venture capitalists sounds a way out!

Venture Capital as a potential alternative financing

Before further looking into the Capital Gap, it is worth to take a look at peculiarities of venture capitalist as opposed to traditional commercial loans:

Alternative Financing	Venture Capital Financing	Debt Financing
Objectives	Maximise capital return	Interest payment
Holding period	2-5 years	Short / medium term
Instrument	Common shares, convertible bonds, options, warrants etc.	Loan, factoring, leasing etc.
Pricing references	P/E ratio, net tangible assets	Interest spread
Collateral	No	Yes (usually)
Ownership	Yes	No
Control	Minority shareholders rights protection and board seat	Loan covenants
Impact of B/S	Reduce leverage	Increase leverage
Impact on cashflow	Improve	Improve
Impact on profit	Improve	Improve
Exit mechanism of capital provider	Public offering and trade sales	Loan repayment

Source: Asian Venture Capital Journal

The venture capital financing pops out to be a feasible alternative source of financing for emerging Chinese enterprises. (Of course, this applies universally to other Asian SMEs as well.) From a risk propensity and risk management point of view, venture capital may be a more readily available and longer-term financing in the post- Crisis era.

Entrepreneurs' Misconceptions for the Venture Capitalists

Historically, the venture capital industry is considered to be a closed and private business circle. The entrepreneurs have a number of misconceptions towards the venture capital industry. The author recaps the 10 most common misconceptions:

1. The demanding venture capitalists will control the company and dictate what the entrepreneurs shall do.
2. Evolutionary business idea is the most important factor for considering an investment proposal. Management quality is a secondary consideration.
3. Only investment proposal from companies with tangible products (either revolutionary, innovative, evolutionary products or substitutions) will be considered by venture capitalists.
4. Personal reference is essential before a venture capitalist will consider a potential investment project.
5. Venture capitalists are either interested in high-tech start-ups or expanding companies with well-established track record.
6. Venture capitalists demand a risk premium on their investment and entrepreneurs can satisfy this requirement by providing reasonable investment return.
7. Venture capitalists are concerned about investment performance and may demand annual cash dividends which may drain the company's cash resources during its development stage.
8. Venture capitals are responsive risk-takers and quick decision-maker and disburse the investment money.
9. Venture capitalists, being private investors, have no fixed investment time horizon and no rigid investment realisation requirement.
10. Venture capitalist is a financing option for expanding enterprises. Entrepreneurs shall consider venture capital as alternative financing providers and treat them in exactly the same way as handling other banking relationship.

With the establishment of industry association and the industry become more transparent to the business community, more and more people become familiar with this industry and most of the earlier misconception have been wiped out. However, a general perception still exists among the business community which considers venture capital as another form of alternative non-bank financing. The venture capitalists are though to be unconventional commercial bankers accepting higher-than-normal risks and more willing in extending credits to SMEs.

How Venture Capitalist can help

Venture capitalists do not restrict themselves to providing alternative financing to SMEs in need. They are actually bridging the capital gap and helping the entrepreneurs to institutionalise a platform for future growth. The venture capitalists get this done by siphoning the necessary expansion capital and furnishing valued-added management and strategic insights to the SMEs.

Five Stages of Small Business Growth" model

To exemplify how venture capitalists could fuel the business growth momentum from an academic perspective, the author will adopt the "Five Stages of Small Business Growth" model[19].

Growth Stage	Major Business Strategy
Stage I **Existence**	- obtaining customer and delivering the product / services. This stage is characterised by a simple organisation with the owner-manager taking the lead.
Stage II **Survival**	- after proving the business ideas are workable, it is a matter of revenue and expenses management. It is a matter of the business's ability to generate positive cashflow to survive. The owner-manager may, at this point of time, seek professional advice to strategically position the business to chart out the future success.
Stage III **Success**	- this is to maintain profitable status quo and get the necessary resources to grow. It concerns an important choice of whether to (a) exploit the company's accomplishments and expand or (b) keep the company stable and sustains the profitability.
Stage IV **Take-Off**	- Now the main business concern is "growth". The key management problem is how to grow rapidly and how to finance that growth. This is also the time to build-up a full-fledged corporate infrastructure to prepare for the future growth.
Stage V **Resources Maturity**	- Essentially, this is return of investment to the anchor investors. The management focus is to (a) consolidate and control the financial gains brought by rapid growth and (b) retain agile and responsive to changing business demands in light of expanding corporate size.

The availability of different sources of capital, primarily debt or equity, depends primarily on the developmental phase and the probability of successful commercialisation.

[19] Neil C., Williams & Virginia L, Lewis. "The Five Stages of Small Business Growth". The Harvard Business Review. May - June 1983: 30 - 50.

Does this business idea work?

The purpose of the initial stages (**Existence** and **Survival**) is to evolve a business to a point where it has three key elements that will spell success:

1. an economically viable product or service with attractive markets;
2. an established business plan that can be replicated; and
3. a seasoned management team that has demonstrated that it can execute the business plan.

Most business idea comes from brainstorming, for example, speculating on how the application of a technology can better fill customers' needs. Some successful businesses are even the result of serendipity or the accidental discovery of a desirable product or service. The idea is then refined, researched and tested on a very limited scale in the feasibility phase. The primary question to be answered in this phase is: "Does this business idea work?" Market research using secondary sources and initial evaluations of the business economics has to be performed to assure the attractiveness of continued investment of time and money.

A key objective in this stage is to gain an in-depth understanding of the customer's needs and how the product or service may be modified to better meet their needs. During this phase, the venture begins to evolve into a business, and key people are added to build the management team.

Scaling up business operations

In the **Success** phase, the firm begins to scale up its operations to prove that it has a business formula that can be replicated and rolled-out for business success. The product is refined for efficient, low cost production, and pre-production lot sizes are produced to show that consistent, acceptable units can be produced. An established selling approach is applied to a broader set of customers, such as those in a wider geographical area. The completely assembled key management team demonstrates that it has the ability to implement a plan that can address a wider, possibly national market.

Fostering the corporate infrastructure as a platform of growth

In the **Take -off** phase, major investments are made to achieve efficient, low-cost, full-scale production and for full-scale market development. For some firms, the investment in manufacturing plant and equipment can be many millions and even billions. The investment can be for the purpose of introducing the product or service to a wider scope of customers, such as spending for advertising or to build a national sales force. Such investments may even be significantly costly than spending money to expand and upgrade the manufacturing facilities. This is especially true for service businesses.

After highlighting this 5-stage model, the author now moves to how elaborate his idea of how the stages of business growth is associated with changing needs of financial and management resources and how venture capitalists could step in to help.

Reducing risk level and dynamic financing needs

The author is of the opinion that the duration of time needed by an individual firm to pass through the different phases is an important factor that influences the amount and kind of money that a firm can seek, and this timing also influences the business' chances to obtain money. The longer the time to reach the later stages, the lower the chance (or more difficult) to obtain some sources of capital.

The cash needs of a venture increase with each phase. The capital base shall be broadened as the company grows, and the costs of failure or exiting from the business a its later stage also increase.

From a (credit) risk management viewpoint, each developmental stage should reduce uncertainty or risk and each phase should increase the probability of success of the business.

All decisions to provide funds to a venture are tied to somewhat subjective risk and reward trade-offs. The higher the perceived uncertainty and risk, the fewer the sources of capital which will be available, and the higher the return demanded by investors who do participate. The lower the perceived uncertainty of successful commercialisation becomes, the more accessible financing will be. Furthermore, lenders are likely to demand less of a share in the company because the perceived market value of the firm will be greater. The process of moving a business through the phases must reduce uncertainty and improve the probability of success.

The major sources of funds for firms in the earlier stage are, hence, restricted and commonly include

1. Debt (for discussion purpose, we ignore the Renminbi convertibility and stability issue)
2. Government Grants / Subsidies (quire uncommon for foreign-invested enterprise in China)
3. Seed Capital / Equity and major Private Placement
4. Venture Capital

Debts from banking sources are generally not a major source of funds for ventures prior to the **Take-Off** stage. An entrepreneur may obtain loans to financing the business' initial operations using personal savings or assets as collateral.

Lenders want low uncertainty of repayment and require collateral. Business does not develop sizeable and verifiable assets such as accounts receivable, inventory, and manufacturing equipment, until they reach the later stages. Government loans, if any, are tied to the assets of the firm, mostly to bricks and mortar, and they occasionally still require the personal guarantee of key management.

Capital from individuals is often the key source of capital for most firms prior to the commercialisation phase. This is particularly true for the cash needed for the start-up firms at earlier stages. These funds are most often in the form of equity. Equity is supplied from the entrepreneur's own cash from savings and monthly cash that is provided because the entrepreneur and his associates often take a sub-standard wage during a venture's earliest phases. Equity can be raised by the entrepreneur's personal efforts to sell stock to a personal network of potential investors (in the Chinese business community, the buyers are usually personal friend, family members and relatives of the entrepreneur). Venture capital firms are a source of equity capital for start-up firms.

Most often, venture capital is not available until the firm has reached the late-**Survival** stage or early-**Success** stage, and possibly not until the firm is ready for **Take-offs**. Many venture capital firms want to invest where the time horizon is medium-to-long term, since they must liquidate their investments in 3 - 7 years and provide cash return to their investors over a finite period.

Linking Financing Needs and Stages of Business Development

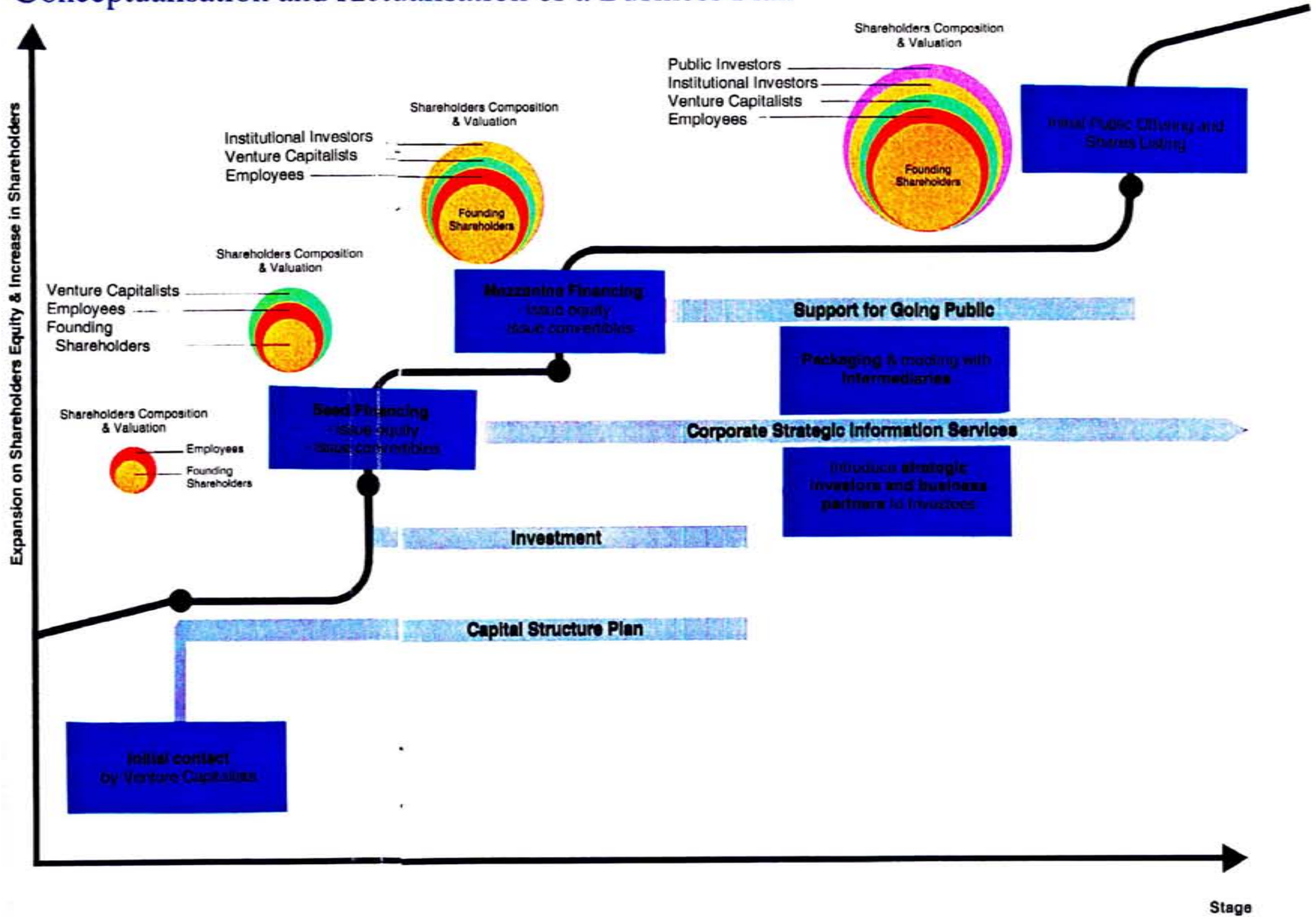
The author summarises below the financing needs and source of funds for businesses at various stages of development. (Obviously, with the recent credit retrench and banker's reduced risk propensity, non-bank financing is being more and more important.)

Growth Stage	Major Strategy	Financial Position	Source of Fund
Stage I Existence	- existence	- start-up - initial / seed capital	- Owner self-financed - Family-financed
Stage II Survival	- survival	- sustain existing operations	- other non-bank financing - VC firms
Stage III Success	- maintain profitable status quo - deploy resources to grow	- seek self-sustaining - buildings financial back-bone	- self-generated cash - bank financing - leasing / factoring companies
Stage IV Take-Off	- growth	- extensive CAPEX - increased working capital need	- issue commercial paper - syndicated loans
Stage V Resources Maturity	- return of investment	- shareholders payoffs - adding investor value	- securitization - IPO

To demonstrate how a venture capitalist could really help in propelling the growth of an SME, we could make reference to the exhibit that follows (see next page).

This attached exhibit diagrammatically illustrates how venture capitalists could team up with owner-managers and helps to actualise their ambitious business plan. The venture capitalists provides the necessary seed and mezzanine financing which consolidated the enterprise's capital structure and built up a solid shareholders base. Venture capitalists and the owner-manager also worked together to nurture and build-up the business franchise.

Conceptualisation and Actualisation of a Business Plan



This exhibit demonstrated and illustrated graphically

1. How venture capitalist provides seed (and initial) financing to support a business concept and enriches the shareholder base,
2. How venture capitalists support the business growth by introducing strategic and other partners to the investee company,
3. How venture capitalists packaged and presented the investee company to institutional investors fur further broadening of the shareholder base as well as providing the necessary expansion capital for take-off, and
4. How venture capitalists and institutional investors help the investee company to go public and attain maturity.

All these are advice and services the investee companies cannot reasonably expect their ordinary bankers to provide. That's why the author would personally refer venture capitalist to "architect of shareholder value".

Before analysing how venture capitalists select their target investee companies, evaluate a business, structure these direct investments deals and make investment decisions, we first take a look at the following typical investment structure of a private equity (more common term for Asian "venture capital") deals:

Typical Investment Structure

Tenor	:	3 - 7 years
Amount	:	US$ 2 - 5 million
Exit Strategy	:	At least one identifiable exit strategy, ideally listing in 2 - 4 years
Country	:	Growing economy with conducive government policies and / or regulations
Industry	:	Growing industry and products in demand
Company	:	Common selection criteria • proven management track record • up-to-date technology • proven business performance with growth potential/clear business strategy • competitive edge over competitors • good market position
Stock Market	:	Reasonable market capitalisation with reasonable liquidity

The author is of the opinion that what venture capitalist are buying into are:

1. untarnished management integrity,
2. forwardness in entrepreneur vision accompanied by viable business plan, and
3. splendid growth potential.

Key Investment Concerns of Venture Capitalists

Although venture capitalists are perceived to be risk-takers, they will be vigilant in doing their homework to mitigate their investment risks. Venture capitalists commonly will assume the role of back-seat value-added business adviser. They usually take minority equity interests and count on the entrepreneur to take care of the daily business operations. Hence, management integrity is their utmost concern.

The venture capitalists are actually buying into "fundamental" and they need a reliable business partner as industrial operator to visualise the business plan. They will favour seasoned business partners who share with them the investee company's

- strategic direction and positioning
- corporate business information
- management & operations control, and
- upside of business success

The author summarised venture capitalists' basic concerns to the "business fundamentals" and "reliable business partners" in the four key questions that follows:

Four Key Questions Venture Capitalists will ask

Venture Capitalists' Question	Typical Entrepreneur's Answers
How much is the up-side return and downside risk?	Annualised IRR of 20% is the upside while the down-side is US$5 million plus US$1 million loan guarantees from shareholder.
Who will be the other stakeholders and how they show their commitments?	The management team and their track record in the business. Their responsibility and level of involvement in this project and their initial investment of US$3 million.
How can you reach your customers and what is the market size?	Independent market research report, strategic action plan of the company plus supplier / customer references.
How can I realise my investment and when.	Identifiable IPO within 3 years plus put option granted to investor from the management team.

In particular venture capitalist will collect information of the industrial operator as they know this owner-manager shall be the one who drives the company and really understand the business. Again, the author summarised the venture capitalists' concern below:

Four Key Management Quality to Look Into

Key Management Quality Venture Capitalists' will Look Into	Venture Capitalists Concern
Market familiarity	Management competence is the key element for all venture capitalists in considering a deal.
Sustainable management efforts	Existing management run investee company and venture capitalists need to ensure continuity of management team and company operation.
Problem Solvers & Goal Seekers	Management shall exhibit sound management visions and the ability to implement this vision.
Trusted Business Partner	Venture capitalists will work closed with management to "grow" the company, hence goal alignment is necessary. Management team's openness and their willingness to share business and operational information are also essential.

Now, the author guesses we have to conclude that venture capitalists are not only risk-takers, they are cautious risk-takers. My industry experience indicated that a typical venture capital investment house seldom funds more than 2 - 5% of the potential investment deals they seriously analysed and evaluated.

Gap Bridging: Self-Evaluation for Business Plans

To increase the likelihood of being picked by venture capitalist and to get the necessary expansion capital , before going to meet venture capitalists, Chinese emerging business should bear in mind the main business and management questions highlighted above. These questions shall be the corner stone of venture capitalist's pre-investment due diligence.

These Chinese emerging businesses could also conduct a self-review on their business plan using the following suggested checklist:

Sample Self-Evaluation Checklist for Business Plans

Key Element	Assessment
(Note [20]) Packaging & Presentation	Is the project or venture plan packaged in such a way that it will facilitate busy venture capitalists in grasping the salient features of the deal in the shortest possible time?
Deal Structuring	Is the salient features of the deal structured in such a way that the potential investor will compel you and invest in your project?
Market Research	Is the market positioning of the company (include growth potential, industrial rivalry and other competitive forces) clearly illustrated?
Financial Projection	Is the financial projection sensibly presented using sound basis of assumptions?
Management Team	Could the illustration for management team members and their track records cast adequate confidence for potential investors?
Return and Exit Mechanism	Could both the investor and the existing stakeholders generate reasonable return and clear exit mechanism established.
Final Test	If the presenter of a business plan take the perspective of a "potential investor", (1) are all salient deal features properly presented, (2) could investor concerns adequately answered, and (3) will the presenter spend the time to consider investing in the project

A key Chinese element not highlighted above is "Regulatory Issues". The author have to admit businesses operating in a dynamic and emerging market got to live with uncertainties. This uncertainty, however, could be mitigated by a through study of environmental and regulatory framework that underlines the business operations.

[20] McCready, William. President of National Venture Capital Association, Hawaii Branch.

Key Elements in Structuring a Private Equity Deal

The previous chapter highlights a typical investment deal structure for a private equity deal. The author does not intend and does not have the liberty previously to highlight how such investment structures are come up with, however, the author thinks this question could has be entangled.

After highlight the venture capitalist's investment concerns, the following generalisation could be adopted as the broad guiding principal for private equity deals structuring, namely,

1. Early (or timely) return of capital to venture capitalists.
2. Premium paid for the risk taken by the venture capitalists in the early development stage of a SME.
3. Other incentives ("kickers"). (These need not be monetary in nature.)
4. Options to increase equity share or liquidate early. Either to share the upside or provide downside protection.
5. Tax and legal considerations.

Partnering with Venture capitalists: a Win-Win situation

To be frank, the driving force underneath the choice of financing alternatives are, in most cases, returns to the business and provide of capital. The following hypothetical case illustrates a possible win-win situation after entrepreneur teams up with a venture capitalist.

Financial Impact on Investee Company

The following example illustrates the possibility of a win-win situation. It is also interesting to note that the entry of venture capitalists broadens the shareholder base and reduces bankers' perceived risk rating on the corporate capital structure. All these could increase the enterprise's capacity to raise further loan financing.

To narrow down the scope of our hypothetical analysis, we only take a look at the expense side of the financial statements and ignored the synergy effect of teaming up of entrepreneurs and venture capitalists.

($ million)		Owner-Managed Business (no venture capital involvement)				Team up with Venture Capitalists			
Year		*0*	*1*	*2*	*3*	*0*	*1*	*2*	*3*
P/L Account									
EBIT			200	260	338		200	260	338
growth rate	30% p.a.								
Less: Interest @	10% p.a.		(80)	(80)	(80)		(80)	(60)	(40)
Profit before Tax			120	180	258		120	**200**	**298**
Profits tax @, say,	15%		(18)	(27)	(39)		(18)	(30)	(45)
Profit after Tax			102	153	219		102	**170**	**253**
Balance Sheet									
Assets, net		1,000	1,102	1,255	1,474	1,000	1,102	1,272	1,525
Loans - short-term #		400	400	400	400	400	400	200	200
Loans - long-term #		400	400	400	400	400	400	200	200
Total debts		800	800	800	800	800	800	400	400
Share capital		200	200	200	200	200	200	250	250
Share premium								350	350
Retained earnings			102	255	474		102	272	525
Total capital		200	302	455	674	200	302	872	1,125
Total debt and capital		1,000	1,102	1,255	1,474	1,000	1,102	1,272	1,525
Financial Ratio Analysis									
Total D/E		4.00	2.65	1.76	1.19	4.00	2.65	**0.46**	**0.36**
Current Ratio *		1.00	1.10	1.26	1.47	1.00	1.10	**2.54**	**3.05**
Interest coverage			2.50	3.25	4.23		2.50	**4.33**	**8.45**

* assume current assets / total assets = 40%

assume venture capitalists' subscription money is used to repay short-term & long-term loans @ 1:1 basis and venture capitalists come in on July 1 of Year 2.

Financial Impact on Investor / Shareholder

My brief return analysis that follows indicated that despite entrepreneur share some of the up-sides to venture capitalists (who enjoys a 23% return), his own equity entitlements in monetary unit increased by 15% as well.

Of course, this is only a simplified scenario analysis as no venture capitalist will disburse investment money to entrepreneurs for re-payment of bank loans.

Venture capitalists will always demand their investment money channelled to more productive sectors, however the author believes the point that a possible win-win situation could thus rise has been made.

Return Analysis		**Entrepreneur**		**Venture Capitalist**
($ million)		No teaming up with venture capitalists	Teaming up with venture capitalists	
PAT @ IPO (Year 3)		219	253	253
Market capitalization Before dilution @ P/E	12x	2,632	3,040	3,040
Value of enterprise attributing to				
- Owner	80%	2,105	2,432	
- Venture capitalists	20%			608
Financial result of strategic teaming			↑ 15.5%	23.3%
		(Additional return to owner)		(IRR% for 2-year holding)

YC

Appendix I: Alternative Non-Bank Financing

FINANCING ALTERNATIVES [21]	ADVANTAGES	DISADVANTAGES
Trade credit o Provides short term borrowing by stretching out payments to suppliers o Usually financed by suppliers	o Easier to obtain due to competitive pressures o No formal instruments	o Expensive (implicit interest) o Potential credit rating problems
Accounts receivable assignment o Receivable are assigned to lender o Company is responsible for collection o Can borrow a specified percentage (usually around 80%) of current receivables o Usually financed by finance companies and commercial banks	o Flexible borrowing o Immediately converts receivables to cash	o May require periodic audit of receivables by lender o Effective rate may be increased by delay in crediting receipts
Factoring o Sale of receivables to third party o Can be with or without notification to customers o usually financed by finance companies and factoring companies	o No collection responsibilities (with customer notification) o No credit risk	o Expensive o Commissions and credit risk will be hidden costs o High interest rate
Inventory loans o Can employ floating liens, warehouse receipts or trust receipts o Financed by commercial banks	o Cost of financing may be lower than receivables financing	o May be available for relatively small percentage (e.g., 50%) of inventory

[21] Adopted and extracted from "Guide to Obtaining Financing", Arthur Andersen & Co., 1985.

FINANCING ALTERNATIVES [21]	ADVANTAGES	DISADVANTAGES
Bankers' acceptance o Draft drawn by a supplier on the company's bank becomes an acceptance when accepted by bank o Collateral is goods being shipped o Useful if seller is unwilling to extend unsecured trade credit due to large size of order or in international trade o Financed by commercial banks	o Facilitates trade of large quantities of goods to be shipped over long distances o Acceptance can be discounted	o Commitment fees
Mortgages o Lien on real property used as security for repayment of a debt o Issued through a municipality o Interest may be tax free o Finance by financing companies and commercial banks	o Long term financing	o Requires down payment o Costly to arrange o Location restrictions o Restrictive covenants requirements
Leasing o Used for asset acquisition or utilization o Variety of leasing vehicles o Lessor maintains ownership o Payment in form of fixed payments o Either financed by manufacturer's finance subsidiaries, finance companies, leasing companies and commercial banks	o No down payment (100% financing) o Provides off balance sheet financing o Less time consuming to establish o Predictable costs o Potential tax advantages o Lessor may provide maintenance service	o Residual value usually goes to lessor o Higher cost than debt o Value of improvements to leased property may accrue to lessor

Chapter 6

Industry Analysis

We seek to wrap-up our industry discussion by conducting an analysis for the China venture capital industry based on the conceptual framework put forth by Professor Michael E. Porter in 1980.

By looking into the 5 competitive forces as proposed by Porter that determine an industry's profitability, we seek to identify where the China venture capital industry is and where it is going. Porter's model work well for economies where the market operation is essentially deregulated i.e. a competitive market free from extensive government intervention. This is, definitely, not the case for China. The distortion effect of government policy will also be considered by the author.

We will explore the suitability of the model's application to a semi-regulated economy and seek to incorporate certain China-specific institutional factors to enrich Porter's model.

There's no resting place for an enterprise in a

competitive economy ... ...

... ... strategy is not the consequence of planning,

but the opposite: its starting point.

Michael Porter's Structural Analysis of Industries

This is an innovative conceptual framework put forth by Professor Michael E. Porter at Harvard Business School in 1980. This model is a useful conceptual framework in

- determining long-term industry profitability
- explaining supplier demand relationship
- defining industry structure or underlying economic / technological characteristics
- guiding business strategic planning to select strategies to ride the competitive forces and to attain the enterprise' competitive advantage.

It is by far, the most commonly adopted analytical framework for industry analysis. The practical value of the framework builds upon its intuition in highlighting the 5 competitive forces that determine an industry's profitability.

These 5 forces determines

- the price (the entry P/E or subscription structure in for venture capitalists) the enterprises can charge, the cost (finance risks and commitments) they have to bear and the investment they need to compete effectively in the industry.
- the threat of new entrants that can limit the overall profit potential in the industry
- power buyer and supplier (deals sourcing etc.) that can further "bargain away" the industry players' profits.
- fierce competitive revelry that can erode profits by requiring higher cost of competing (say, legal expenses and debt-to-equity conversion terms etc.).
- presence of close substitute products (other capital market alternatives) that can limit (or "guide") the venture capitalists' entry price without inducing substitution and eroding industry volume.

Michael Porter's Five-Forces Model

The 5 competitive forces that determine an industry's profitability, according to Porter, are:

1. intensity of rivalry among industry competitors
2. threat of New Entrants
3. threat of Substitutes
4. bargaining power of Buyer
5. bargaining power of Suppliers

[b] **T**hreat of **N**ew **E**ntrants
:
:
[a] **I**ntensity of
[d] **S**uppliers........................... **R**ivalry among .... [e] **B**uyer
Industry competitors
:
:
[c] **T**hreat of **S**ubstitutes

Firm are not prisoners of their industry structure. Through their adopted strategies, firms can influence the five forces and therefore shape industry structure, making it either more or less attractive. Such strategies are a double-edged sword since a firm, after gaining a critical mass, can destroy industry structure and profitability as readily as it can improve it.

The ability of firms to shape industry structure places a particular burden on industry leaders as their actions can have a disproportionate impact on structure for their perceived firm size and their influence over buyers / suppliers and other competitors.

Industry Structure and Equilibrium

Industry profitability and viability is a function of the dynamic equilibrium between the supply and demand side. Industry structure determines how rapidly competitors could add new capacity. The effectiveness of entry barriers underpins the likelihood that new entrants will enter an industry and stir up the price equilibrium. The intensity of rivalry plays a "determining role" to decide whether existing firms will expand their capacity aggressively or choose other competitive actions.

Our initial analysis on China venture capital industry will focus on the following:

[a] Industry Rivalry Factors

o industry growth & institutional investors involvement
o over-capacity escalating competition
o product differences & brand identity
o concentration and balance
o competition from corporate ventures
o exit barriers

[b] Entry Barriers
o legal constrains / government policy and investment restrictions
o brand identity
o access to quality deal flow
o capital requirement

[c] Substitution Threat Determinants
o relative performance of other capital market substitutes
o investees' propensity to substitute

[d] Suppliers (investees) Bargaining Power Determinants
o presence of substitute inputs
o venture capitalists concentration

[e] Buyer (venture capitalists) Bargaining Power Determinants
o differentiation of inputs from venture capitalists
o buyer switching costs vs. enterprise switching costs
o buyer deals in pipeline flow & portfolio strategy
o substitute products and brand identity

[a] Industry Rivalry Factors

o Industry growth & institutional investors involvement

The industry growth is a function of relative supply of (a) readily-available public financing, bank credit and other private sector financing (such as securities market and debt market) against (b) availability of a relatively-expensive pool of venture capitalist's money within the prevailing regulatory and stakeholders right protection framework.

The institutional investors' participation greatly enhances market efficiency and the overall regulatory environment. These institutional investors also help to develop a local pool of venture capital talents who are more well-positioned to boost the acceptance and growth of venture capital industry in the local business community.

Almost every leading local conglomerates and corporations have, somehow, institutionalised an in-house business development function whose mandate greatly resemblance and mimics that of their counterparts in the venture capital community.

o Over-capacity and escalating competition

Over-capacity is a proliferating problem for most Asian countries and is draining the investment return of venture capitalist by pushing up the entry price. The reason for this could be categorised as "too many money chasing too little quality deal flow".

Contrary to conventional wisdom, this over-capacity problem worsens in the post-Crisis era. Not all venture capital houses could have the liberty to change their inter-country assets allocation limits (as this may rigidly be prescribed by their investment mandate). Venture capitalists investing in the "*less-desirable*" Asian countries may encounter undue pressure to invest. This pressure may force them to accept unreasonably-high entry price commanded by "promising" local entrepreneurs to hasten their effort in disbursing idle investment capital.

These "promising" enterprises easily stands out among their less-desirable local counter-parts and could easily leverage their position in negotiating with the "deal-starving" venture capitalists.

o Product (and value added) differences & brand identity (for pre-IPO placement)

To alleviate the negative impact of price competition which tends to erode the industry's profitability (industry benchmark for investment return typically stands as high as 25% - 30% p.a.), non-price competition elicited.

Professional venture capitalists differentiate themselves by the wide range of value-added services (including strategic planning, further fund-raising assistance and human resources advisory) they offered to investee companies. Accordingly, brand-identity of investment houses is highly sought by investees who usually associate the capability of investment houses with their established image and brand names. This is of particular importance for investees seek to expand their shareholder base in preparation for a forth-coming IPO.

o Concentration and balance

Venture capitalists and their in-house risk management experts typically command a desirable make-up of the portfolio of investee companies. Such asset allocation requirements are typically expressed in terms of assets concentration limit with reference to industry (economic sector) or country concentration.

As the shift in investment preference and focus among the competing investment houses are generally in line with the changes in asset allocation of their respective competitors, this potentially elevates the industry competition. (This is self-explanatory as it goes without saying that bargaining power of investee companies in certain favoured industry will multiply in this respect.)

o Corporate stakes (competition from corporate ventures)

Venture capitalists, who behave as a pure-financial investor, will be return-oriented and will not have an innate preference for certain industry sectors. This is not, however, the case for corporate venturers.

This group of investors could be labelled as cash-rich conglomerate's in-house venture capitalists whose pricing strategies are generally in line with that of venture capitalists from independent investment houses. However, due to their source of capital, they may prefer investee companies in certain sectors (say, a wooden furniture manufacturing group's in-house corporate venturer may prefers an up-stream forestry plantation project) and more willing to paid a higher-than-normal entry price.

Corporate venturer's presence will potentially drive up the overall entry price into investee companies in certain industrial or economic sector.

o Exit barriers

Owing to relative limited exit alternative (due to a under-developed M&A market in China etc.), IPO and trade-sale may be the most viable exits for venture capitalists. This imbalance market will inevitable stir-up industry competition due to the inherent preference of the capital and M&A markets.

Currently, those PRC investee companies have an established brand-name and market distribution channels are typically favoured as a potential IPO candidate and take-over target. The "qualified" potential investee companies thus have exceptional bargaining power.

[b] Entry Barriers

o Legal constrains / government policy and investment restrictions

There are virtually no entry barrier for foreign (or domestic) capital into the PRC business community. However, there is significant legal restrictions on the structuring aspects. This greatly limits the creativity on deal structuring for seasoned venture capitalists.

Currently, foreign participation on a number of industries such as retail / department stores, petroleum refineries and telecommunications are restricted and highly regulated. (The PRC government claims that the main thrust for imposing such foreign-equity participation is to protect infant domestic enterprises that lack the financial resources and state-of-the-art expertise to survive the sudden influx of foreign competitors.) Seasoned venture capitalists are all prepared to spare additional efforts to shatter these regulatory constraints.

o Brand identity

Despite there are no effective entry barrier for foreign investment capital, the leading domestic corporations (as potential investee companies) seeking foreign investors generally favour well-known (or high-profile) investment houses which are perceived to be better-positioned to create value-added synergy effects among their extensive portfolio of investee companies.

o Access to quality deal flow

In a country with relative under-developed channel of information flow within the business community (such as China), there is little or no publicly-available information on potential deals. There is also no open forum where venture capitalists could meet the potential investees to match their capital needs. New entrant venture capital houses to this market may face significant problems in their start-up phase.

This could be a difficult task for independent venture capital houses who does not have any commercial banking / investment banking affiliates to help them in deals sourcing. The new-entrant's costs of pioneering and tapping into new markets could be high! This strive could also be time-consuming as well.

o Capital requirement

Venture capital, as the name suggest, is an inherently high-risk long-term investment alternative. The investors shall be prepared to have their investment capital lock-up for at least 3 - 5 years before they could reap a reasonable return.

Taking into account the relative long-term nature of venture capital investments, the supply of capital is highly restricted. Supply of venture capital mainly come from sophisticated high-worth individuals and established corporations who has adequate recurrent income from a matured portfolio of investments (which could mitigate the high risk of venture capital investment). It is not easy task to find new source of capital, in particular, during this post-Crisis era.

[c] Substitution Threat Determinants

Venture capital is a typical non-bank financing open to emerging / developing enterprises and expansion projects whereby a typical commercial bank usually perceive the business risk to be too high for their credit assessment exercise.

Commercial banks emphasis risk management and seldom extend credit (in return for an interest spread) to emerging / developing enterprise and / or expansion investment projects. Other typical non-bank financing include "project financing" which is somewhat restricted to projects with a visible set-up of investments.

To finance emerging / developing enterprises and expansion projects, equity-related securities (either listed or unlisted) is a common alternative.

o Relative price performance of other capital market substitutes

The higher the price of other capital market substitutes to the investee companies, the lower will be the threat to venture capital products in view of the high cost of venture capital financing involved.

o Investees' propensity to substitute

This is predominantly a function of availability of other capital market products. If the market expects return on capital market products to soar, more capital market resources will be available to the investee company at a lower price. Consequently bring a much higher substitution risks for venture capital products.

However, for committed investments pending completion or fund disbursements, the investees' propensity to substitute is very low as the venture capitalists should be able to lock-in the deal by demonstrating their value-adding capabilities to the investee companies.

[d] Suppliers (investee) Bargaining Power Determinants

It is not easy to give a precise definition of supplier and buyer within the China venture capital industry context. However, for illustrative purpose, "suppliers" are being defined as potential investee companies (seeking venture capital-type financing) and is broadly defined to include existing majority shareholders as well as existing management (usually owner-manager) of the investee companies. (Accordingly, "buyers" are being defined as providers of venture capital-type financing.)

o Presence of substitute inputs

As discussed in the preceding paragraphs, other banking and non-banking financial products are competing with venture capitalists. However, none of these competitors could match the value-adding capability of venture capitalists. Investees seeking mere financial resources will, typically, turn to other non-venture capitalist products whereas investees seeking non-financial assistance will normally turn to venture capitalists.

o Venture capitalists concentration

In the post-Crisis era, polarisation of enterprises become more conspicuous. In the post-Crisis liquidity squeeze and deteriorating business operating climates, enterprises are either struggling for survival or delivering exceptional (in the post-Crisis standard) financial performance to its investors.

Venture capitalists, despite their high risk propensity, will cluster around and compete among each other for the opportunity invest in the healthier companies and providing expansion capital for them. These group of "healthy companies", on knowing their value, will ask for high entry price and will even shopping around different houses to bargain for a good price (i.e. demanding for a high entry premium).

[e] Buyer (venture capitalists) Bargaining Power Determinants

o Differentiation of inputs from venture capitalists

Venture capitalists with established local and overseas market connections and track record have very high negotiation power. They have already demonstrated their impeccable ability to deliver a value-adding service to investees and have a higher chance to create synergy between their portfolio of investee companies.

Those venture capital houses associated with investment banks or commercial banks will have additional bargaining power as their could (potentially) bring additional financial resources and other expertise to the investees.

On the other hand, smaller independent venture capital houses have relatively limited bargaining power and thus being forced to commit themselves to more risky (or less profitable) projects. This group of venture capital houses are not competing head-on with their larger peer groups. They tend to be more specialised and targeted at a particular market niche. "Specialisation" is the commonly-adopted mitigating measure for smaller independent venture capital houses engaging in more-risky projects.

- Buyer switching costs vs. enterprise switching costs

For committed deals (pending completion or actual fund disbursement), hurdles of switching cost for both buyer and supplier are exceptionally high. This is, however, not the case before the deal is committed. During the earlier negotiation and deals structuring stages, there are virtual no switching cost for both two sides.

- Buyer deals in pipeline flow & portfolio strategy

Judging from the overwhelming uninvested idle capital earmarked for China direct investment, the smaller venture capital houses with less strong deal flows and potential projects in pipeline may face undue pressure from their shareholders / investors to perform i.e. to have the idle capital committed as soon as possible.

Accordingly, they may develop a tendency of accepting less desirable investment project and exercising less bargaining power at their side. This, however, may not be the case for large venture capital houses who have a broader base of shareholders / investors as well as a more matured portfolio of investee companies.

On top of the pressure to perform, the venture capital houses may "waive" their negotiation and bargaining power in their strive to attain their respective (in-house designated) desirable portfolio balance and asset allocation targets.

- Substitute products and brand identity

The competition from substitute products (essentially other non-bank alternative financing) are only limited taking into account the higher risk-tolerance level of venture capitalists and the peculiar nature of the private equity deals.

The private equity nature and the value-adding services, however, generally favours larger private equity houses who are perceived to possess the necessary financial and other management skill and carry a premium brandname. To be frank, the reputation of the investment house, at times, may be the most important decision criterion in the eyes of a suppler.

Refining Michael Porter's Model and Incorporating China Elements

The above discussions demonstrated the Venture Capital industry to be a "human" based value-adding service. This also exemplified the importance of human factors (and interaction between buyers and suppliers) that features the industry growth factors. Apart from providing expansion capital, "value-adding strategic advice" is another important element in venture-capital type financing.

On top of this, China-specific legal and regulatory constraints should be the other force guiding the development of venture capital industry.

Taking into the Chinese peculiarity, "Value and Management" should be the conditioning factor underlying "Rivalry among Industry Players". This is the hurdle that distinguishes a seasoned venture capitalist from a conventional one.

As the author have hinted at the beginning of this chapter, the "Legal and Regulatory Environment" should be another refinement introduced to the Porter model.

"Legal and Regulatory Environment"
(investor and minority protection)

[b] Threat of New Entrants

[a] Intensity of
Rivalry among
[d] Suppliers .... Industry competitors .... [e] Buyer
focused at
"Value and Management"

[c] Threat of Substitutes

Value and Management

In the human respect, "Value and Management" should be incorporated to Porter's model. This should be part of the rivalry among industry competitors. In economic terms, the industry players are competing in the "monopolistic competition" spectrum and engage in fierce non-price competition in the "value and management" aspect.

These two factors, in my opinion, means cementing the three forces that drive the growth and operations of a JV,

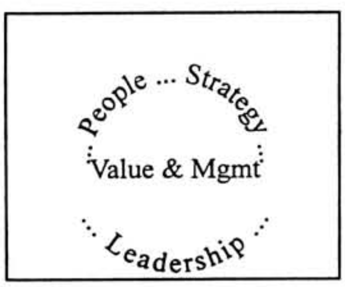
1. people,
2. leadership and
3. strategy into action.

This concept emerged from the author's prior experience that the PRC joint venture partners might have a "hidden agenda" when they entered into JV agreement.

Sino-foreign joint ventures (both equity and contractual) are, by far, the most popular forms of vehicles for foreign direct investment (especially for the foreign venture capitalists investing into China). Typically, the Chinese partners usually have affiliations with other companies handling things like supplying raw materials to the JV and handling product distribution for JV. This pertinence is usually considered as a key decision criterion for foreign investors in assessing and choosing a Chinese JV partner.

In most cases, the JVs are actually a way of taking out profit from these areas. It goes without saying that foreign investors shall look out for hidden agenda at their Chinese joint venture partners' side. In most circumstances, it is difficult to ascertain the real co-investment intention of the partners.

The basic ideas are:



Value -- the ultimate objective of all business organisations.

Management -- exercises control over the other economic elements of inputs and conduct an orchestrated operations toward the value production.

I. Value

"Value" points toward the ultimate stakeholders. In western business world, the predominant goal is to produce profits and growth for the benefit of the company's shareholders. In PRC, this can be a complicated situation as it may be hard to locate the real stakeholders. Before entering into any private equity deal in China, the venture capitalists (and the foreign investors) shall ensure the joint venture partners (between the Chinese and foreigner partners as well as among the group of foreign partners).

Typical examples that may lead to nightmares include marriage between

1. a PRC joint venture partner seeking access to foreign manufacturing technology transfer and a foreign partner whose goal is to penetrate PRC domestic market without any real intention of technology transfer, and
2. a foreign financial investor (say a venture capitalist) seeking to reap medium-term financial success and a foreign industrial operator who seeks to establish a Chinese strategic outpost for long-term market development and market leadership.

II. Management

"Management" exercises control over the other economic elements of inputs and conduct an orchestrated operation toward the value production. Specifically, management plans and organises, leads, and controls the business operations. They are also responsible for establishing strategy and action plans for strategy implementation. Their behaviour pattern is, in turn, shaped by their *value*.

Where the management (typically not appointed by the venture capitalists) will share the management vision, strategic planning direction, financial and operational information with the venture capitalists (and other stakeholders) determines the venture capitalists' ability to deliver value-adding advice to the invest companies.

Putting Competitive Strategy into Action

In summary, "value and management" means cementing (1) strategy, (2) people and (3) leadership together and turning their brainchild into productive action steps.

This means base on an agreed-upon and recognised **value, management** formulated a business **strategy** that uniquely positions the enterprises or long-term prosperity. To transform this strategy into results, the management will formulate a strategic action plan which seeks attainment of corporate goal through **people** (including staff members, suppliers and customers) under their **leadership** and command.

Legal and Regulatory Environment

Foreign investors investing into China could not structure their investment strategy and projects at their own will. Typical in most emerging markets, the foreign investors encounter a number of legal hurdles which regulated their efforts in realising their PRC market penetration endeavours. Even for a foreign investors to acquire interests in another foreign-invested PRC enterprises (not to mention a debt-ridden State-owned Enterprise), the buyer should undergo an extensive time-consuming and expensive legal procedures (see box that follows for some of these legal requirements)

Registration of FIEs as Corporate Shareholders or Sponsors Several Provision (Promulgated October 10, 1995)

This provision applies to FIEs which invest in a limited liabilities company or a company limited by shares in their own name and using their own assets and are registered as shareholders or sponsors of such companies. This regulation describe the circumstances under which a FIE may register as shareholders / sponsors of such company and the documents that to be submitted to the original supervising registry when such enterprise invest as shareholders /sponsors. This regulation also prohibits a company from investing in other companies using more an aggregate of more than 50% of its net assets.

China Company Law (Promulgated December 29, 1993 & Effective July 1, 1994)

It is stipulated that a company may invest in other limited liability companies but the aggregate amount of investments may not exceed 50% of the investing company's net assets. It is also stipulated that merger and acquisition of companies may take the form of "merger by absorption" and "merger by new establishment" and give details as to how these procedures are to be effected.

Foreign Investment Industrial Guidance (Revised) Catalogue (Promulgated: December 31, 1997)

This guideline lists those industries that are encouraged, restricted and prohibited with respect to foreign investment.

(Source: Allison Shaw, Editor, and China Direct Investor)

Legal Aspects of Joint Venture Restructuring

Since China promulgated its first law on joint ventures using Chinese and foreign capital in 1979, joint ventures have been the most important vehicles siphoning foreign investments into China. From time to time, these joint ventures may have to be restructured by the investors and, at times, these changes are so fundamental that warrants extensive regulatory and legal scrutiny and sanction.

Chinese law requires all establishment of Sino-Foreign joint venture companies be governed by Chinese law and approval by relevant Chinese government authorities. The law also specifies the "organisational documents" of a joint venture, which shall be approved by relevant authorities and typically consists of

1. feasibility studies,
2. joint venture contract, and
3. articles of association.

Within this set of comprehensive documents, the following important organisational aspects, *inter alia*, will be specified, (1) the business purpose, (2) total planned investments, (3) aggregate equity contribution, (4) debt financing scheme and (5) important aspects of corporate governance (including composition of board members and manner in which senior executive is appointed).

This is necessary for Chinese government to ensure the proposed investment in line with central government policies. Any subsequent change to the aforementioned items requires changes in the organisation documents and prior government approval is required.

The following paragraphs[22] list out typical joint venture restructuring situations which requires prior government approval:

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[22] Li, Xiaoming and Xu, Richard. "Legal Issues Surrounding Restructuring of Joint Ventures ". China Law and Practice Guide. August 1998: 27-35.

I. Change of Investment

Any change of registered share capital, change in the joint venture parties' relative equity interest in the joint venture as well as the joint venture's authorised level of debt-raising requires government approval.

Legal complications involved here may include "additional" central government approval if the increased total investments (total registered capital plus debt) exceeds US$30 million. Statutory debt-to-equity ratio as well as a 20%-equity ceiling for contribution-in-kind (say technological transfer) are being imposed. Due care should be exercised to ensure these statutory ratios and ceilings are strictly observed before AND after the joint venture restructuring.

II. Change of Parties

Change of joint venture parties is always a major change that requires approval from the Chinese government authorities that originally approved the joint venture and a unanimous approval of the joint venture's directors attending the board meeting. Securing this approval may be time-consuming and using an offshore special purpose holding vehicle is a method commonly adopted to avoid the Chinese regulatory hurdle over change of joint venture ownership.

III. Change in Management

The general rule is the party that controls the board of a joint venture also controls its management. A change in management of a joint venture is often caused by the change in equity holding structure.

IV. Change of Business

Parties to a joint venture may change the business scope or line of business of a particular joint venture. However, this change must be approved by the relevant government authorities and by a unanimous board decision. On top of this, attention should also be given to the following issues:

- *Investment policies.*
  The Chinese government (periodically) updates the foreign investment guidelines and restrictions may apply to joint ventures in certain industries. Any change of the joint venture business should stay clean at all times such restrictions.
- *Additional Feasibility Study.*
  The joint venture may be required to prepare a new feasibility study report on the new business undertaken by the joint venture as if the joint venture is in the process of obtaining its initial approval from relevant government authorities.
- *Tax Consequence.*
  Chinese tax laws encourages joint ventures to engage in long-term manufacturing, high-tech and infrastructure projects by giving generous tax holidays. Such privilege would be lost if the joint venture was no longer engaging in the original encouraged industry.

Merger and Acquisitions Opportunities Ahead

In the context of Asian Financial Crisis and the wide-anticipated growth slowdown in China, foreign strategic investors with a clear understanding of Chinese reality combined with a focus on neatly-organised investment strategy can be expected to encounter more flexible officials and more sophisticated Chinese business partners.

The legal infrastructure system is now largely in place for creative and pragmatic investment structures. Dedicated and properly constituted negotiation teams from foreign investors are more likely to succeed.

Foreign Acquisition of State-Owned Enterprises

Since the 15th National Communist Party Congress in September 1997, the green light seems to have been given by China's highest authorities that Chinese State-Owned Enterprises are "for sale". In December 1997, the Chinese Central Economic Work Conference outlined five principles guiding the SOE reform.

It appears to the observers that the theme of China's SOE reform campaign is "*zhuada fangxiao*" -- literally, "grasp the large (SOEs) and release the small (SOEs)". Hence, the State is perceived to be divesting medium and small-sized SOEs and strengthening and streamlining the business operation of large SOEs.

More than ever, foreign investors are needed to provide capital and modern management techniques to the old-fashioned SOEs. The Chinese government, however, have yet to formulate adequate rules and regulations with respect to foreign investors' acquisition of SOEs. Foreign companies could only acquire the assets of

SOEs through their PRC joint ventures or wholly foreign-owned enterprises. Up to now, foreign investors are still not expressly permitted to directly acquire State-Owned (legal person) shares of listed or unlisted companies.

The author expects foreign investors will soon be permitted to acquire interest in SOEs and this shall be the future topic that calls for numerous attention and spotlights.

Sum Up: Legal Aspects of China Investment Projects Structuring

To sum up, despite numerous regulatory restrictions and constraints, the creative foreign investors should still be able to find a way to structure their China investment strategies and action plans.

The author believe the next China Fever (after cooling of the early-1990 one) shall be fuelled by Chinese government's opening up of the private equity market which allows foreign investors to acquire equity shares (and even controlling interest) in domestic enterprises.

One thing we have to bear in mind is: whether the Second Wave of China Fever could crystallise or not is a matter of how Chinese government could foster a legal (and legal enforcement) system to pave the way for the influx of foreign expansion capital.

Chapter 7

Lessons Learned

From what we have shared in the earlier chapters on (1) China foreign direct investments, (2) evolution of venture capital industry in more matured markets, (3) Asian entrepreneur's peculiar requirements for expansion capital, as well as (4) the dissection on the industry growth forces in China, the author will propose some ideas on

4. Critical success factors for venture capital house operating in China,
5. Model venture capital investing house, and
6. Road-map for a 21st Century Model Investment House.

This chapter intends to be a wrap-up for the project and endeavours to associate (1) China investment climate, (2) regulatory concerns, and (3) business practices to devise a strategic China investment plan for a venture capital house.

Critical Success Factors for Venture Capital Houses Operating in China

The author considers the following to be critical success factors for venture capital houses operating in China:

1. look for proven service concepts that can be transplanted into China
2. team up with local or foreign industrial partner
3. conduct extensive market research
4. legal concerns (investment retractions & regulatory frameworks)
5. undertake extensive pre-acquisition due diligence
6. maintain active and supportive oversight of investees

(This set of critical success factor should be universal to venture capital houses whose do not specialise in any particular industry. If a particular venture capital house seeks to specialise in certain industrial sector, adequate industry-specific knowledge should be an additional critical success factor.)

We will further look into this set of critical success factors in the following section.

1. Looks for proven service concepts that can be transplanted into China

Experience learned by entrepreneurs from established mature market could be applied in an "anticipatory basis" in China. This necessitates application of sophisticated market research and demand forecast techniques in a well-defined target market segment. This exercise should aim at catching emerging business opportunities in response to local market's stage of economic development, demographic pattern and GDP consumption power) growth.

The pioneering foreign operators started setting up outposts in strategic locations in major Chinese cities well before eruption of market consumption power being recognised and identified by their competitors. Instead of being a mere follower who choose to wait for the trend to emerge and then ride on it, they strive to initiate a ripple and turn it into a new wave of customer demand. Their pioneering and forward-looking PRC expansion plan give rise to their superior market position and profile which, in turn, substantiated their market shares, leadership and sustainable super-normal profits.

A number of Western-style chain of fast-food shops and hyper-markets who already became Chinese household names (such as McDonalds, Kentucky Fried Chicken, Carrefour and Sam's Club) are typical successful examples in anticipating PRC local market demand.

To mitigate the market diversity and sophisticated market segmentation, venture capital houses could opt to specialise itself in certain market segment, say a particular geographic segment (say Shanghai municipal or Guangdong province) or industrial sector (say light manufacturing, retail or aeronautical products).

2. Team up with local or foreign industrial partner

Maintaining a profitable business operation in an emerging and dynamic market like China is not an easy task. Conducting business in emerging market where the market definition are loose, legal regulatory framework are less predictable and, occasionally, facing uncertain government industrial policy requires a well-balanced pool of management talent with a board spectrum of knowledge.

The techniques required include (a) unprecedented forward-looking management vision, (b) unreserved management commitment with well-defined business focus, (c) uncompromising determination to excel in the market segment and (d) arduous and sustainable effort in building a strong corporate infrastructure and coherent policy to implement shared corporate goals and cultures.

All these inputs could be sought from a well-established industrial operator who already mastered the prerequisite manufacturing expertise, management know-hows and ability to create a full-spectrum customer reach in China. The ideal case is teaming-up with a local industrial operator who posses the market knowledge and established a national-wide distribution network together with a foreign industrial operator who could bring in state-of-the-art manufacturing know-hows and workshop techniques.

3. Conduct extensive market research

China domestic consumer market should be considered a fragmented market with highly complicated segmentation due to its (1) varying cultures, (2) volatile customer demands, and (3) geographic disparity (stages of economic development in different provinces). Newcomers to the Chinese market should avoid taking a gross generalisation and over-simplification attitude in formulating their China business plan. (Significant difference in customer preference could exist even in the same geographic area.)

The fundamental factors shaping local customer demand should be adequately understood before product launching and marketing. This shall be the most important step in achieving an adequate market penetration and coverage for all business managers in China.

It stands to reason that a market research with adequate coverage within a well-defined target market segment is indispensable. This is the fundamental in assessing the commercial viability of all business ventures in China.

To venture capital houses, this means they have to not only thoroughly assess the width and depth of a potential market, but also focus on more fundamental issues: does the market really exist in terms of actual consumption power? It is uncommon to see failure of "promising" investments in "promising" market sector due to inability to channel "promising" consumption power into "real" customers orders.

4. Legal concerns (investment retractions & regulatory frameworks)

In light of the semi-open and the highly-regulated market structure, the overall legal and regulatory frameworks shall be sufficiently understood and dissected to minimise unplanned disruption to the business operation.

This is a fundamental concern for both the venture capitalists and business operators.

5. Undertake extensive pre-acquisition due diligence

Taking into account the problems highlighted within this report, in particular, hidden agenda of the (foreign and local) co-investors, their divergent risk-reward matrix and strategic planning priorities, an absolute requirement to perform extensive due diligence is thus emerged.

The investment premises and criteria of the other co-investors should be thoroughly explored and understood. The potential investment opportunities and their target markets, should also be evaluated on a global / regional perspective.

One of the key issues venture capitalists should address is: is there any adverse hidden agenda behind the business partner's business plan which is detrimental to building a long-term mutual-beneficial relationship?

6. Maintain active and supportive oversight of investees

As highlighted in this report, the fundamental difference between a bank creditor and a venture capitalist is the value-adding advice and exchange of management ideas. The venture capital houses should maintain an active and supportive oversight for their portfolio companies (e.g. frequent site visits and close contacts with the business managers). This is of particular importance to co-investors, despite being leaders in their particular business sector, who do not have a full-spectrum and diversified understanding of Chinese business practices and techniques.

Prescription for a Model Venture Capital Investment House

It's nature for readers to raise the following question, "In light of the given set of successful factors, which venture capital firms are the most likely to succeed?". My ideas for answering this question is " ... it is those houses who have secured access to adequate financial resources and established in-house corporate infrastructure will excel in this competitive industry!"

More specifically, these potential final contestants for future star performers in the venture capital industry are those with:

1. *Adequate infrastructure and personnel.*

   Firms have an extensive network of local investment professionals in each local country have a higher likelihood to succeed. The differentiating feature for these houses are having local investment managers (who have acute local business expertise) work together with regional officers (who brings in regional / global perspective) on potential investment deals. In light of increased competition for deals, intra-regional co-operation to source potential investment could be an added advantage.

2. *Vast financial resources.*

   Firms being part of larger (global or regional) financial institutions which can reduce reliance on outside limited partners for financial resources also have a higher likelihood to succeed.

3. *Diversified financial and management skills.*

   In light of the rapid-changing and demanding requirements in the post-Crisis arena, those houses with strong corporate finance skills and M&A knowledge having a higher chance to survive and prosper in the demanding and increasing-sophisticated market.

4. *Regional investment flexibility.*

   Firms have regional funds, without pre-set country or industry allocation, thereby providing investment flexibility could have superior chance to survive in the post-Crisis era -- they are free from undue pressure to invest.

Road-map for a 21st Century Investment House

In light of the high risks associated with emerging market investment, from a risk management point of view, venture capital houses should focus on providing expansion capital i.e. to capture opportunities from enterprise that have passed the risky development stage and looking for expansion capital. These enterprises already demonstrated reasonable proof on viability of business, management capabilities, and competitive edge.

To boost the overall portfolio return, a certain percentage (say 5 - 10%) of the fund could be allocated to more risky areas (say promising greenfield investments) which may offer tremendous investment returns "potentially". Blindly following and transplanting the US model of concentrating in greenfield start-up high-tech businesses does not appear to be a sound approach for Asian venture capital industry.

Another principle that should be observed is avoid the "commitment escalation" approach in the strive to turn-around under-performing portfolio investees. Once a less-than-desirable investment decision is make, a more direct approach to alleviate this situation is " wiping out from balance sheet" instead of contributing additional resources in the hope of looking for emergence of a turn-around plan. In an emerging market, choices available to venture capitalists in turning around a non-performing investee companies are more limited than in matured markets.

The author endeavours to sketch a road-map for a 21st century house in the venture capital industry taking into account the Chinese peculiarities and business practices:

	China Market Problematic Peculiarities	Mitigating Approach
1.	o Difficult to attain country-wide reach o Diverse market segmentation and customer preference within the vast market	o Focused investment strategy
2.	o Require versatile technique for emerging market risk management o Requires specialist advice in dealing with different industrial structure at different economic development stages	o Global direct investment presence and team-up with well-established industrial operators
3.	o Difficult to secure traditional financing domestically	o Support market leaders and domestic rising star
4.	o Premature securities market potentially chokes venture capital investors	o Multi-facet exit mechanism
5.	o Dynamic and volatile business environment o Need for responsive and proactive management	o Responsive and prompt decision making process
6.	o Hard to identify investment opportunities in a imperfect market in the absence of well-established market deal flow	o Building deal flow and entrepreneurs networks
7.	o Time-consuming problem associated with tackling regulatory constraint	o Brand recognition

1. Focused investment strategy

The "universal and all-rounder expert" approach in managing venture capital funds is no longer a panacea for successful investment houses in light of the increasing complex business environments. In most cases, over-aggressiveness in an emerging market could only lead to an undesirable dead-end "Jack-of-all-trade" outcome.

This is of particular importance in penetrating a semi-open market with a vast diversity of geographic coverage,

2. Global direct investment presence and team-up with industrial operators

This could lead to pooling of the necessary industrial specialist advice from the industrial operator as well as its pool of business talents and financial planning gurus' skills from the industrial operators' global direct investment experience.

The learning curve for the new business venture could be significantly shortened and give a higher chance for the venture to attain commercial viability.

3. Support market leaders and domestic rising star

In light of the post-Crisis liquidity squeeze, venture capital houses have a better chance to team up with market leaders and SMEs who are fundamentally healthy but suffering from unhealthy across-the-board liquidity squeeze. By providing expansion capital to these enterprise, venture capitalists houses could speed up their investment cycle and getting the desirable results faster.

The problem associated with this is increased exposure to RMB currency risk. As highlighted previously, the risk could be diversified by carefully planning the investment house's global investment portfolio.

4. Multi-facet exit mechanism

Initial public offering has becoming an increasing important exit route for venture capitalists[23]. However, within the under-developed Chinese domestic securities market and absence of second board[24]. The venture capitalist houses, should thus be more flexible in formulating exit mechanisms to avoid over-reliance on IPOs.

Alternative exit mechanism commonly adopted by pioneering venture capital houses is selling matured investee companies to new market entrants through "trade sale" arrangements. This could be a Win-Win situation as the earnest market new-entrants are more willing to paid a higher price to expedite their market entry plan, shorten the market-entry learning curves and acquire existing market share.

5. Responsive and prompt decision making process

Seasoned venture capitalists may recognise that enterprise operating in emerging market may face a broad range of business and strategic dilemmas. All these call for timely response and immediate attention. They will ensure all such business issues are identified in the early stage and properly handled.

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[23] Please see illustration at the end of Chapter 4 which exemplified how IPO can bring the necessary capital appreciation and give an above-20% p.a. IRR return to venture capitalists.

[24] "Second Board" are currently under development in Hong Kong and Shenzhen Stock Exchanges. However, the market depth has yet to be proven.

This will require building a strong corporate infrastructure which could support responsive decision marking process in a dynamic environment. This infrastructure is essential to tackle these emerging unstructured and unprecedented problems.

More importantly, the venture capitalists should be prepared to be a value-adding partner to spearhead management attention and focus of investee companies. To expedite the decision making process and create agility and responsiveness in the investee company level, venture capital houses (as well as management team of the investee company) should devise a prompt decision marking process.

6. Building deal flow and entrepreneurs networks

Unlike in matured markets, there is no established public information channel for potential investment deals or forum of any form that lines-up potential investors with potential investees. Venture capital houses associated with banks or other financial institutions could attain a superior market position by tapping into their banking affiliate's strong local corporate banking network to identify investment opportunities.

In a semi-open market, the ability to source and identify investment opportunities could be the single most efficient weapon to beat the other competitors. It has been well-recognised in the venture capital profession, "Just concentrate in sourcing and picking a good deal, investment realisation and project divestment will take good care if themselves!"

7. Brand recognition

Despite investees shall be indifferent to the provider of their expansion capital, venture capital houses with strong brand-name always outperform their other less-prominent counterparts in tapping potential investment opportunities. The reasons for their superior bargaining power include

a. investment houses' perceived premium ability in delivering value-added advice and assistance to investees,
b. investment houses' more-diversified and well-established portfolio of investees offers additional benefit for portfolios investees to create synergy or strategic alliances, and
c. upon teaming-up with a leading investment house, investee perceives a higher chance to arouse investor awareness in the local business community.

On top of this, having a large portfolio in local business community, the venture capital houses should have a better change to entangle legal and regulatory constraints and dead-locks by leveraging on their investment track records and market profile. This track record cold be of paramount importance (and be the most powerful weapon) in negotiating with PRC local (and even central) government ministries.

Final Words

In conclusion, for a venture capital house to excel in the 21st century marketplace, it should take a pro-active approach instead of an opportunistic approach in formulating its investment strategy and implementing its business plans.

Venture capital industry is a human and relationship-based industry, to ensure a proper execution of their business plan, the venture capital houses should also build up a strong and supportive in-house corporate structure to serve as their platform of growth and business expansions.

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Epilogue

The Chinese GDP Growth Inhibitants ... ...

Despite the encouraging 1998 GDP growth of 7.6%, it is clear that most of last year's growth was fueled by massive infrastructure spending. Undeniably, these aggressive infrastructure project spending has been notoriously known for it inefficiency and unproductiveness. The author sees no reason how this infrastructure could lead to sustainable 1999 GDP growth. I have to admit that the heartening 1998 GDP growth failed to mask a serious structural problem for the Chinese economy -- in almost each and every industry and trade sectors, the Chinese economy is experiencing a recession.

We believe, in the absence of proactive counter-measures, the Chinese economic growth could be retarded by gross over-supply, deflation and unemployment (or the fear of becoming unemployed)

<u>Gross Over-Supply</u>

After more than one decades' exponential growth in output capacity, the Chinese economy is now tasting its own spoon of medicine from its over-expansions in the prior decade.

On one hand, we see the Chinese government making aggressive investment into infrastructure projects, the private sector investments are, indeed, contracting. They are too busy to engage in new investments as they have to handle a more immediate problem - the problem of excess production capacity. This over-supply issue, coupled with the general economic difficulties, are eating into the bottom-line of businesses. With this wounded business profitability, the financial institution is casting significant doubts on the economy and is reluctant to extend credit which further strains the vulnerable domestic economy.

<u>Deflation</u>

This is the undesirable effect brought about by weak consumption and high savings (with 1997 gross national saving amounting to 38.6% of GNP versus a 1997 average of 26.7% for the 16 Asian countries as reported by the Asian Development Bank). This is exemplified by the 2.6% drop in domestic retail price in 1998. To be frank, in light of the economic uncertainty and perceived growth in unemployment, consumers' penchant for saving is no surprise. Without a prosperous consumer and retail market, it will take much longer for the Chinese economy to recoil.

<u>Unemployment</u>

This is a terrible "afterglow" of the current SOE reform and other successful preceding economic reforms. On one hand, these reforms enhanced the economy's productivity, yet caused excess capacity in many economic sectors. Without a high-growth economy, the excessive workforce could not be absorbed and integrated into the economic growth engines.

Government's Hands are Tied … …

The worst part of this story is the lack of effective government policy tools to deal with this problem. The 1999 budget deficit is already projected to rise by 10% and effectively blocked fiscal expansion. Government-backed bond issue to finance infrastructure expenditure appears to be the last card on table.

However, taking into account the notoriously low efficiency of the Chinese infrastructure projects (literally known in Chinese to be the "tofu leftover projects") and the low multiplier effect that rooted from low domestic propensity to consume, chances for these infrastructure projects to attain sustainable GDP and economic growth are slim.

Taking into account the extend of People's Bank of China's cut in interest rate (6 times within the last 24 months) and the yet-to-materialize impact on investor appetite, much doubt is cast on the effectiveness of this traditional policy tool. The same goes for increasing money supply. Western traditional monetary tools for igniting economic growth engine may not work well in China. We have to figure out alternative growth propellant in a semi-closed and self-contained economy where consumer credit and bank financing (to private-sector) have never been important economic element.

The Panacea for Chinese Economy … …

At this point of time, the author is still positive towards the future of China. The only question is could China survive the short-term pain and commit itself to far-reaching structural reform?

China now faces an economic structural problem and the right (and only) medication is "Perseverance" … …

> … … the Perseverance to implement short-term painful reform policies, the Perseverance to create a more level playing field for both local and foreign entrepreneurs, and the Perseverance to foster a better economic platform to attract foreign direct investments.

The Global Investors Concern for China … …

The global investment community have become increasingly concerned about China's economic, financial and, ultimately, political prospects. It has become evident that more and more international investors are looking for alternative locations and future heats for making foreign direct investments. India, Brazil and Russia (despite much currency and political problems) are on the short-list. As economic growth in China slows down and (foreign) capital inflows diminish, more and more disorder is teething in the structure and functioning of the Chinese economy.

At least for the moment, China does not appear to have the "typical" external liquidity problem that has plagued many countries in Asia, Russia and currently Brazil. Rather, at this stage, the Chinese problems are more microeconomic in nature. However, if there is further deterioration and as the delicate economic equilibrium dismantles, macroeconomic problems could eventuate!

It should not be surprising to find economic and financial problems appearing in an economy after such a lengthy period of unprecedented tremendous growth and abundant supply of foreign investment capital. That is particularly so for an emerging market economy like China. But, what really worries the international investors are the other rising problems in China which signal deeper issues such as a general lack of governance, management and control of the economy by the different levels of government and between different levels of government coupled with a lack of transparency inside the working of the economy that nurtures bribery and corruption.

The Foreign Investors are Re-thinking their China Investment Strategies … …

This has already led to some hesitation for foreign investors and a slower growth of capital influx. The resultant lack of political desire to forcefully proceed with much-needed structural reform of state-owned enterprises and the financial sector could be disastrous. Such political desire may spark another new wave of investor concerns. Undeniably, much improvement has already been shown but foreign investors are, indeed, expecting more profound initiatives by the Chinese government.

The positive economic benefits from earlier structural reforms (such as agricultural sector reform and the introduction of special economic zones) have largely run their course in their positive effects on economic growth. To maintain growth that is adequate from both economic and political imperatives requires significant industrial reform. Such structural industrial reform should be escorted by related modifications in complimentary areas such as regulatory framework predictability and banking reform.

While much is being said about reforms, such as SOE and banking reforms, not much appears to have been done to satisfy the foreign investors whose patience and perseverance is gradually declining. Of course, most investors still remain positive towards the structural reforms in China, but some of them already lost their forbearance and immediate action is required to resuscitate their confidence in China.

Is the Chinese Government Taking the Right Medicine to revive the Economy … … ?

To counteract the lack of growth momentum, government infrastructure spending has increased enormously and largely financed by new issues of government debt paper. This spending cannot continue very long under the existing set of fiscal concerns. That gives rise to higher possibility of Renminbi devaluation aim at spurring the foreign trade sector as an engine of growth. This aggressive spending may not produce the desired growth impetus! (Unfortunately, our HK SAR government is applying similar tactics to revive our economy.)

What really counts for the Chinese government's penchant to aggressive fiscal spending is its undesirable consequence. Failure to boost domestic GDP growth by this aggressive fiscal spending may result in sweeping hazard not only causing problems to other Asian countries but also to foreign currency debtors and investors in China.

Heart of the Question … ..

As mentioned repeatedly in this report, China (and emerging market) investing is, basically, an issue of global risk management for international investors. The choice of invest (or not) in China is, in fact,

a Delicate Balance … a Dynamic One as well !

"*S*trategic cost of *NOT* Investing"

against

"*F*inancial cost of Investing"!

This delicate balance is where the magic of China investment (and other emerging market investment) lies!